98th Congress
2d Session

JOINT COMMITTEE PRINT

S. PRT.
98-284

DEALING WITH THE DEBT PROBLEM OF LATIN AMERICA

PROCEEDINGS

OF A

CONFERENCE

ON

TUESDAY, NOVEMBER 13, 1984

COSPONSORED BY THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

AND THE

CONGRESSIONAL RESEARCH SERVICE
LIBRARY OF CONGRESS

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

43-427 O

WASHINGTON : 1985

J842-6

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

SENATE	HOUSE OF REPRESENTATIVES
ROGER W. JEPSEN, Iowa, *Chairman*	LEE H. HAMILTON, Indiana, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware	GILLIS W. LONG, Louisiana
JAMES ABDNOR, South Dakota	PARREN J. MITCHELL, Maryland
STEVEN D. SYMMS, Idaho	AUGUSTUS F. HAWKINS, California
MACK MATTINGLY, Georgia	DAVID R. OBEY, Wisconsin
ALFONSE M. D'AMATO, New York	JAMES H. SCHEUER, New York
LLOYD BENTSEN, Texas	CHALMERS P. WYLIE, Ohio
WILLIAM PROXMIRE, Wisconsin	MARJORIE S. HOLT, Maryland
EDWARD M. KENNEDY, Massachusetts	DANIEL E. LUNGREN, California
PAUL S. SARBANES, Maryland	OLYMPIA J. SNOWE, Maine

DAN C. ROBERTS, *Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

HOUSE OF REPRESENTATIVES	SENATE
LEE H. HAMILTON, Indiana, *Chairman*	LLOYD BENTSEN, Texas, *Vice Chairman*
AUGUSTUS F. HAWKINS, California	ROGER W. JEPSEN, Iowa
OLYMPIA J. SNOWE, Maine	ALFONSE M. D'AMATO, New York

LETTERS OF TRANSMITTAL

NOVEMBER 19, 1984.

Hon. ROGER W. JEPSEN,
Chairman, Joint Economic Committee, Congress of the United States, Washington, DC.

DEAR MR. CHAIRMAN: Enclosed is the transcript of a conference on "Dealing With the Debt Problem of Latin America." This workshop was organized at my request by the Congressional Research Service of the Library of Congress.

The participants at the conference were academics, representatives of both small and large debtor countries in Latin America, bankers, officials of two international financial institutions, senior staff members of the executive and legislative branches of the U.S. Government and Federal Reserve Board. We hope that all points of view were represented.

In addition to a verbatim transcript, there is a summary of the proceedings by the moderator, Alfred Reifman, Senior Specialist in International Economics at the Congressional Research Service.

I would like to thank him, the Congressional Research Service, and George Tyler of the staff of the Joint Economic Committee for organizing such a useful conference. I am sure the proceedings will be in demand by government officials here and abroad, and by students of the subject.

Sincerely yours,

LLOYD BENTSEN,
Vice Chairman, Subcommittee on Economic Goals and Intergovernmental Policy.

NOVEMBER 16, 1984.

Hon. LLOYD BENTSEN,
Vice Chairman, Subcommittee on Economic Goals and Intergovernmental Policy, Joint Economic Committee, Congress of the United States, Washington, DC.

DEAR SENATOR BENTSEN: I am pleased to transmit the transcript of our November 13, 1984, conference on "Dealing With the Debt Problem of Latin America" which was organized at your request.

A wide range of viewpoints were expressed at the conference. Some argued that the debt crisis arose primarily because of the budget deficits of the Latin American countries, requiring them to borrow abroad to finance these deficits. At the other extreme, were those who argued that the prime cause was external conditions—the oil shock of 1973–74 and 1979–80, the economic recession of the 1980's coupled with high interest rates and a very strong dollar.

The policies proposed ranged widely. Some recommended that the problem be decided without the participation of international institutions or the U.S. Government, but that the debtor countries and the commercial banks work out the arrangements among themselves. Others argued that such an approach presented a possible threat to the U.S. banking system and imposed heavy strains on the poor countries of Latin America. A variety of policies were recommended including increased concessional aid by the World Bank.

We hope that you will find this conference useful.

Sincerely yours,

GILBERT GUDE,
Director,
Congressional Research Service.

OVERVIEW—BY ALFRED REIFMAN, SENIOR SPECIALIST IN INTERNATIONAL ECONOMICS, CONGRESSIONAL RESEARCH SERVICE

Since mid-1982, the Latin American countries have been unable to service their foreign debts, posing a threat to the international financial system and to the economic future of the region. The crisis has now subsided, at least for the major debtors and the world banking system. There is now cautious optimism that the current policies of the debtors and economic recovery in the industrial countries will see the debt problem managed and economic growth in Latin America restored.

But the future is far from assured. Huge foreign debts will hang over Latin American economic and political life for the foreseeable future. Moreover, some of the smaller countries may be insolvent; there is little hope that they will be able to service all of their foreign debts.

Origins of the Problem

The debt problem has both international and domestic causes. Clearly, many of the debtor countries were unable to adjust their domestic policies sufficiently to deal with severe adverse world economic developments—the oil shocks of 1973–74 and 1979–80, the extremely high interest rates of 1981–82, the low export volume and prices resulting from the global recession of the early 1980s, and, recently, the strong dollar. Instead, they borrowed heavily to finance their balance-of-payments deficits. Moreover, in some cases, overvalued exchange rates, low domestic interest rates and huge fiscal deficits encouraged capital flight and imports, inhibited exports and required massive foreign borrowing. Indeed, some observers claim that the prime cause of the debt problem was widespread budget deficits which, as is the case of the United States today, were financed by foreign borrowing. There are, however, some countries, such as Chile, with balanced fiscal budgets but severe external debt problems.

Those who argued that poor domestic policies were the prime cause of the debt crisis (notably Larry Sjaastad), pointed to the huge budget deficits which had to be financed by borrowing abroad and the successful adjustment to adverse world conditions of Korea and other NIC's. They also pointed to the huge flight of private capital, amounting to over half the external debt of the major Latin American countries, which better domestic policies could have averted.

Those who argued that external conditions were the prime cause (notably William Cline) noted that $400 billion of the $500 billion increase in the debt of the non-oil developing countries from 1973 to 1982 can be explained by higher oil prices ($250 billion), very

high interest rates and the sharp drop in the value of commodity exports, resulting from economic stagnation and recession in the industrial countries. They also argued that the 30 to 40 countries which got into difficulties at the same time could not all have become fiscally irresponsible simultaneously.

The truth is that both external and domestic factors were important in producing the widespread debt problem.

Outlook

The economic turnaround in Latin America from 1981 to 1983 exceeded expectations. The trade balance swung from a deficit of $0.6 billion to a surplus of $31.4 billion, a $30 billion improvement. The balance-of-payments deficit (current account) was cut from almost $40 billion to less than $10 billion. This was the good news. The bad news was that these achievements were purchased by a substantial cut in imports and the deepest recession, the highest unemployment and the first sharp cut in living standards since the 1930s. Nevertheless, in 1984 economic growth in Latin America was recovering, breaking a three-year period of stagnation and decline.

To a number of observers, particularly Cline, the future looked promising. The Latin American countries would be able to pay interest on their foreign debts and achieve a satisfactory pace of economic growth so long as the expansion in the industrial countries continued at a modest pace (2½ to 3 percent per year), and world interest rates and the dollar declined slightly, as many expect.

Others, focusing on the risks in the economic forecasts, had more pessimistic outlooks:

—Some, Richard Feinberg among others, argued that economic growth in the industrial countries, particularly the United States, might falter. Interest rates might stay high or even rise. The dollar might not fall much, if at all. A successful export expansion by the Latin American states might be met by increased protectionism in the industrial countries.

—Even if such unhappy events did not materialize, and the debt situation of Latin America improved over the remaining years of the decade, the burden would still be heavy and creditworthiness of many debtors still in doubt, with the result that voluntary lending by commercial banks would be quite limited.

Lawrence Brainard, Senior Vice President of Bankers Trust, put it clearly: ". . . there's not a single country in Latin America that would qualify for new lending today or perhaps even for the foreseeable future. The risk ratios are too high . . . even on the most optimistic assumptions they're not going to get down into the desirable range for the rest of this decade. . . . A revival of bank lending is not around the corner."

—Others felt that the austerity programs required by the IMF and crucial for the happy outcome of 1984, could not be sustained. Political pressures would force an easing of current restraints. Per capita income, already low, has dropped and unemployment remains high.

The debt burden will continue to be heavy. For Brazil, debt service over the next three years will be roughly $24 billion, almost

equal to the 1983 record level of exports (Sergio Amaral). The bunching of maturities during the 1987–88 period suggests the "possibility of continued liquidity difficulties and rescheduling through the late 1980s . . ." (U.S. Treasury).

Moreover, Larry Sjaastad with support from Christine Bindert, Senior Vice President of Lehman Brothers, argued that some of the smaller countries, particularly Panama, Costa Rica, Chile, and Bolivia, are insolvent. Their external debt is 100 percent or more of GNP. Such debt cannot be serviced and will have to be written down. This pessimistic conclusion, however, was challenged by Cline.

Policies

What policies are needed to:

—Restore conditions which improve the capacity of the debtor countries to achieve a healthy pace of economic growth, a reasonable balance of payments and a debt-service ratio enabling the country to borrow again from willing lenders.

—Protect the U.S. and world banking system from disruption.

The policy options can be divided into four major categories: debt relief, Latin American adjustment, policies of industrial countries, additional financing.

1. DEBT RELIEF

(a) Sjaastad argued that special financial aid to the debtor countries would end up as aid to the bank stockholders; yet there is no overriding public interest in contributing to their welfare. The alternative he preferred is to let the banks and the debtors divide up the loss among themselves by writing-down the value of the loans. One or more individual banks might fail but the banking system as a whole would not be threatened.

Others pointed out (i) that the public sector (the U.S. Government, the IMF and the World Bank) is not now intervening heavily to help the commercial banks, and (ii) in the unlikely event of widespread defaults by major debtors, many major banks would become insolvent and the results could be catastrophic. Accordingly, they (Cline and Truman among others) argued that it would be irresponsible for policymakers to adopt a passive role if economic and political conditions in the major debtors were to deteriorate substantially.

(b) There was no support among the conferees for establishing an international agency to buy up bank loans at a discount and extend more liberal terms to the borrowing countries. The banks would not be willing to absorb such a huge capital loss. The cost to the new official agency would be large. The credit ratings of the debtors would be damaged. And pressure for further involuntary lending by commercial banks would be reduced or eliminated.

(c) There was wide support for proposals to deal with a future rise in interest rates by establishing another Compensatory Financing Facility in the IMF from which debtors could borrow to cover the increased interest costs, and by encouraging arrangements between creditors and debtors to defer (or cap) interest payments above certain levels.

2. ADJUSTMENT

There was general agreement that the Latin American countries had to shift resources to exporting by adopting appropriate exchange rates, reducing fiscal deficits and eliminating various measures inhibiting more efficient use of resources.

Doubts were raised about the ability of governments to sustain current austere domestic policies given widespread unemployment and low and declining real wages.

In addition, Richard Feinberg argued that the Latin American countries were transferring resources to the industrial countries because interest payments exceeded net capital inflow and the major Latin American countries were running large trade surpluses. Cline pointed out that though this was a real burden on living standards in Latin America, it was essential if the debt-service ratio was to be reduced to levels which would permit a return of voluntary lending. Some argued, moreover, that it was not a real transfer of resources since Latin America was still running balance-of-payments deficits on current account.

3. U.S. POLICIES

The conferees agreed that U.S. policies to reduce the budget deficit and further ease monetary policy would make a major contribution to easing the Latin American debt problem by lowering world interest rates and reducing the value of the dollar. This would also be in the U.S. interest. Similarly, avoidance, if not the reduction of, U.S. import restrictions would facilitate the repayment of debt, and would be in the U.S. interest as well.

4. ADDITIONAL OFFICIAL FINANCING

The conferees generally agreed that additional concessional lending, particularly by the World Bank but also some medium-term lending by the IMF, was needed. Some were skeptical that it would be forthcoming or, if it was, that it would be well used, i.e. it would be used to postpone rather than advance the economic adjustment process already underway.

CONTENTS

	Page
Letters of Transmittal	III
Overview—By Alfred Reifman, Congressional Research Service	V
DEALING WITH THE DEBT PROBLEM OF LATIN AMERICA	
List of Participants	1
Opening Remarks—By Gilbert Gude, Director, Congressional Research Service	1
International Debt: Outlook and Issues—By William R. Cline, Institute for International Economics	2
A View From:	
A Large Country—By Sergio Amaral, Brazilian Embassy	23
The Smaller Countries—By Christine Bindert, Shearson-Lehman, American Express	35
Contrasting Experience of Latin America and Korea—By Larry Sjaastad, University of Chicago	49
A Banker's View—By Lawrence Brainard, Bankers Trust	64
The U.S. Government's View—By Ciro DeFalco, U.S. Treasury	75
APPENDIXES	
A. The Latin American Debt Problem—U.S. Treasury	83
B. External Debt and Debt Service: Some Country Differences—By Larry Sjaastad, University of Chicago	98

DEALING WITH THE DEBT PROBLEM OF LATIN AMERICA

TUESDAY, NOVEMBER 13, 1984

The conference was convened, at 9:40 a.m., in the Mumford Room, James Madison Building, Second and Independence Avenue SE., Washington, DC, Mr. Alfred Reifman, Congressional Research Service, moderator.

LIST OF PARTICIPANTS

Workshop: Gilbert Gude, Director, Congressional Research Service; and Alfred Reifman, Moderator, Congressional Research Service.

Speakers: William Cline, Institute for International Economics; Christine Bindert, Shearson-Lehman Brothers, American Express; Sergio Amaral, Brazilian Embassy; Lawrence Brainard, Bankers Trust; Ciro DeFalco, Department of the Treasury; and Larry Sjaastad, University of Chicago.

Panelists: Elinor Constable, Department of State; Andre DeLattre, Institute for International Finance; Jorge Espinosa-Carranza, Inter-American Development Bank; Jeffrey Frankel, University of California, Berkeley; Richard Feinberg, Overseas Development Council; James Galbraith, Joint Economic Committee; Kristin Haliberg, Colby College; John Henderson, Congressional Research Service; Anne Krueger, World Bank; Paul Krugman, Massachusetts Institute of Technology; Bart Rowen, Washington Post; Ted Truman, Federal Reserve; Arlene Wilson, Congressional Research Service; Walter Eubanks, Congressional Research Service; Morrie Goldman, Congressman Jerry Lewis; Karen Morr, CIA; and Patricia Wertman, Congressional Research Service.

OPENING REMARKS—BY GILBERT GUDE, DIRECTOR, CONGRESSIONAL RESEARCH SERVICE

Mr. GUDE. I am Gilbert Gude, Director of the Congressional Research Service, and I want to welcome you to this conference on the debt problem of Latin America.

We are very pleased to have an excellent panel of experts to deal with the debt problem of Latin America in response to a request by the Joint Economic Committee.

Alfred Reifman, our moderator, is a Senior Specialist of the Congressional Research Service. He has a long background in international economic problems in the Department of State and the Council of Economic Advisers as well as the Library of Congress. Al has participated in most of the major international economic

initiatives since the end of World War II—the development of the Marshall Plan, the establishment of the OECD and the European Common Market, the adoption of flexible exchange rates, the reduction in trade barriers uder the GATT. Educated at Michigan, he's taught at Yale and American University. Some of you know that he was a weather forecaster. So don't take everything he has to say too seriously. Al, thank you so much for putting this program together.

Mr. REIFMAN. Thank you, Gilbert.

This conference is an attempt to understand the Latin American debt problem and to evaluate the various ways to deal with it. All of you are experts or at least specialists who have worked on the problem as academics, representatives of the debtor countries, bankers, officials of the U.S. Government.

Our first speaker is Bill Cline, who is going to present an overview of the debt problem.

INTERNATIONAL DEBT: OUTLOOK AND ISSUES*—BY WILLIAM R. CLINE, INSTITUTE FOR INTERNATIONAL ECONOMICS

ORIGINS OF THE PROBLEM

Mr. CLINE. In August, 1982 Mexico temporarily suspended payment on external debt. Since that time the international financial system has faced a debt crisis that has crippled growth in developing countries and threatened the major banks of industrial countries.

The origins of the debt problem were both international and domestic. The increase in debt of the non-oil developing countries from 1973 to 1982 was approximately $500 billion. Of this amount, approximately $400 billion may be attributed to exogenous shocks. The impact of higher oil prices was approximately $250 billion. Extremely high interest rates above historical real levels in '81 and '82, combined with low export volumes and low export prices during the global recession, accounted for about another $150 billion.

Although these estimates are from partial analysis, even a more comprehensive analysis taking account of induced adjustment would have to conclude that external shocks had a major influence. The large role of external shock is confirmed by the fact that 30 or 40 countries all entered into debt problems simultaneously.

At the same time, there were clearly domestic causes as well. Capital flight was a major problem in some of the most important debtor countries, especially Venezuela, Argentina, and Mexico. Domestic policies caused overvalued exchange rates and maintained interest rates too low to keep capital at home, encouraging massive capital flight. In Argentina, which has a debt of about $44 billion, about $20 billion or more would appear to be attributable to capital flight, since this amount cannot be accounted for by the accumulation of current account deficits.

The growth of exports compared with the interest rate on debt serves as a useful summary indicator of the viability of debt. Debt

---

* This analysis draws on my recent study, International Debt: Systemic Risk and Policy Response (Washington, DC: Institute for International Economics, September 1984).

tends to grow at the rate of interest, because there are inherited payments due on past debt that increase debt, and these payments are based on the interest rate. One would expect that exports need to grow as fast as, or faster than, the level of the interest rate for debt to remain viable and not mushroom relative to exports.[1]

In the 1970s, this race was being won. Exports were growing at about 20 percent, while the interest rate averaged about 10 percent. But in 1981–82, exports grew by only 1 percent, and the interest rate was 16 percent. With the advent of the debt crisis this crucial test was being failed.

SYSTEMIC RISK AND POLICY RESPONSE

After August, 1982 developing country debt for the first time posed a systemic risk for not only the countries involved themselves but also for the industrial countries. The reason for risk to the financial system is that the bulk of the debt is owed to banks in the industrial countries, and this debt is large relative to their capital. The nine largest US banks have loans outstanding to developing countries and Eastern Europe equal to 280 percent of their capital. Clearly, a very sharp cut in the real value of this debt would pose the risk of insolvency for some of these banks. Mexico and Brazil each individually account for about 45 percent of the capital of the nine largest banks and much more for some of the individual banks.

Policymakers recognized that there was a systemic threat. Banks are highly leveraged so that their losses, if they were to materialize, could have multiplied effects. Banks act as a fulcrum of an inverted pyramid with the economy at the top. There could be multiplied effects for the rest of the economy if there were widespread bank failures.

In view of the risks to the banking system, the policy community acted forcefully when the debt crisis arose. Policymakers quickly mounted financial rescue packages for Mexico, and then for Brazil and other countries, that involved three basic structural elements. The first was a commitment by the country itself to take adjustment measures in conjunction with the International Monetary Fund. The second was the provision of additional lending by the banks as their part of the package. Third, the public sector committed financial resources, through the International Monetary Fund, the Export-Import Bank, the BIS, and in some cases through direct loans from the US Treasury Department.

The conceptual premise of this strategy, which today still remains the underlying assumption of management of the debt problem, is that the problem was one of temporary iiliquidity appropriately managed by the extension of additional lending, and not a problem of long-term fundamental insolvency requiring in some sense a massive write-down of the debt. A crucial question is whether this policy diagnosis has been accurate and whether it remains so today.

---

[1] However, if the country runs a trade surplus that is used for paying some or all of the interest, exports may grow more slowly than the interest rate without causing an escalation of debt-export ratio.

ILLIQUIDITY OR INSOLVENCY?

I have attempted to examine the question of insolvency versus illiquidity through the use of a simulation model that projects the debt and balance-of-payments of the 19 largest debtor countries through 1987. The basic question is whether under plausible international economic conditions the debt burden will return to more manageable proportions and, in particular, whether creditworthiness indicators such as the ratio of debt to exports or the ratio of interest to exports will return to levels that are associated with normal capital market access.

In my model, for each country, I relate the volume of exports to OECD growth and to the country's own real exchange rate. The prices of exports depend on the rate of world inflation. They also depend on the dollar because if the dollar depreciates by 10 percent, for example, the dollar prices of traded goods will tend to rise by perhaps 8 percent. Otherwise, if the dollar were going down a pound of coffee with an unchanged dollar price would command fewer resources from Germany and Japan, and it would not make sense for the real value of a pound of coffee to decline simply because of a change in the cross exchange rate. Finally, export prices depend on OECD growth. If that growth rate increases, there is an improvement in the developing country's export prices, based on past empirical data.

The model has imports related to the country's own domestic growth rate and, again, to the real exchange rate. Interest payments depend on the level of international interest rates. The value of oil trade is driven by the price of oil.

In the calculations which I made in April 1983, which were first reported in a Wall Street Journal article, and then published in September, 1983,[2] I made central assumptions about the international economy and these other variables and came to the conclusion that as long as OECD growth could stay at a threshold of about 2.5 percent or perhaps 3 percent, there would indeed be an improvement in the various creditworthiness indicators. Essentially, recovery of the international economy would bring export growth and increases in export prices, and a probable depreciation of the dollar would further increase dollar prices of traded goods and the value of the export base. The diagnosis of my 1983 estimates was that the problem was one of illiquidity, not insolvency. The same finding applied to the major individual countries.

INVOLUNTARY LENDING

However, the analysis indicated that it would take three years or more to return to more traditional levels of creditworthiness. The question arose, how would the system deal with the debt problem until then? To answer this question, I suggested a model of "involuntary lending." Involuntary lending is defined as a situation in which new participants in the capital market would not make

---

[2] Lawrence Rout, "New Study Indicates World Debt Crisis May be Solved as World Economy Spurts," Wall Street Journal, 26 May 1983, p. 34, and William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Policy Analyses in International Economics, No. 4, September 1983.

loans to the country because the envrionment is too risky, but existing participants who have outstanding exposure in the country will find it attractive to make modest new loans in order to shore up the quality of the old loans. Technically, the expected benefit of a new loan equals the resulting reduction in the probability of default multiplied by the outstanding exposure. The expected cost of the new loan equals the amount of the new loan multiplied by the terminal probability of default.

There is a difficulty in the implementation of this strategy by banks that are sufficiently small and do not believe that their own actions affect the probability of default. They can refrain from increasing their exposure, but in doing so they benefit from the increased exposure of the larger banks that are shoring up the quality of the outstanding debt of the smaller banks as well. This is the so-called "free-rider" problem. In practice, the banking community exerted peer pressure to induce the smaller banks to go along with new lending. In addition, the International Monetary Fund adopted a historically new strategy, which was to make its funds conditional on participation by the banks in the expansion of their exposure. This process essentially internalized these external economies. It helped marshal joint action by the banking system as a whole so that all of the potential freeriders, or most of them, actually participated in the process of expanding exposure.

RECENT EVIDENCE

The actual experience of 1983 was considerably more favorable on the external sector than even my projections had indicated. The improvement did tend to occur primarily, however, in the form of lower imports than anticipated rather than higher exports. Nonetheless, some of the individual performances were quite striking. Mexico in its IMF program was slated to have a deficit in 1983 of $3 billion. Instead, it achieved a surplus of $5.5 billion on the current account. Brazil achieved an ambitious trade surplus target of $6 billion in 1983.

For the 19 largest debtor countries world-wide, the current account deficit declined from $56 billion in 1982 to $23 billion in 1983, a much sharper declined than I had projected in my model of April 1983. Overall, in terms of actual performance on the external sector, 1983 was considerably better than than most observers had expected.

In 1984, there has been a continuation of this favorable trend. The driving force has been the emergence of a strong OECD recovery. OECD growth this year should reach almost 5 percent, instead of the 3 percent that many had anticipated. High OECD growth has a strong influence on exports, and export prices. Again, in 1984, the individual trends are quite impressive. Brazil is expected to run a trade surplus of over $12 billion instead of $9 billion, the target according to its IMF program. Mexico, once again, will be running a large current account surplus.

The broad experience of 1983–84 is a rather strong confirmation of the basic diagnosis that was made by some studies, including mine, in early 1983 that the problem could be managed on the basis of international economic recovery. Obviously, not everything

has turned out as well as one would have liked. In 1984, by the second quarter, interest rates had risen by 2 percentage points, although they have started to come down again now. Moreover, the dollar has risen instead of declining.

On the other hand, growth in the industrial countries in 1984 has been considerably higher than expected and the benefits of growth outweigh the costs of the extra interest burden. On a conservative basis, in the first year, extra export earnings from 1 percentage point of additional OECD growth offset extra interest costs from about 3 percentage points of increased interest rate for the non-oil developing countries. The relationship is less favorable for some of the most heavily indebted countries such as Brazil. Interestingly enough, even in Brazil this year there has been a far larger rise in exports than in the interest burden. In particular, Brazil's exports should rise by about $5 billion this year, whereas a 2 percentage point rise in interest rate—if it were sustained—would have meant about a $1.5 billion rise in interest costs.

An obviously unfavorable part of experience to date is the very severe recession in the developing countries. In 1983, the Latin American countries had a decline in their GNP of 3 percent. Their per capita income in 1983 was about 10 percent lower than in 1980. Essentially, because of the very bad start, the decade of the 1980s is likely to be a lost decade for Latin American growth. However, a turnaround has begun in growth as well. Growth in Brazil this year is likely to be 2 to 3 percentage points, and in Mexico, it is likely to be on the same order of magnitude. In 1985 and beyond there should be considerably higher growth rates.

New projections which I completed in July of 1984 confirm the earlier conclusion that the debt problem is manageable and will show considerable improvement. The new projections assume OECD growth of 4.2 percent in 1984, a conservative figure. The projections allow for growth recessions, so that OECD growth is 2.7 percent in 1985, 2.4 percent in 1986, and then returns to 3 percent.

The new projections assume more unfavorable interest rates than before, with LIBOR at 12.5 percent in 1985, turning down to 9.5 percent by 1987. Oil prices again hold at about $29 a barrel. The dollar depreciates by 10 percent in 1985 and another 10 percent in 1986. Developing country growth is assumed to be 4.5 percent annually, which should be sufficient for political sustainability. Permanent recession is not required for these countries to deal with the debt crisis.

In the new projections, the current account deficit hovers in the range of $30 to $40 billion for the 19 largest debtor countries through 1987 even though dollars are eroding in real value and the export base is rising. The ratio of net debt to exports of goods and services declines from 200 percent in 1983 to 140 percent for these countries in 1987. The trends of strong improvement continue for some of the key debtors. Mexico's net debt-to-export ratio declines from 300 percent to 200 percent, and Brazil's from 370 percent to 225 percent. The Argentine projections are again for a strong trend of improvement, but they do capture a less favorable base in 1983. With the better data on debt and with some lag in export growth from that which I had anticipated, Argentina's debt-to-export ratio in 1983 was an extremely high level of nearly 500 percent. The new

projections nonetheless show a strong improvement to about 300 percent by 1987.

The new projections are probably too favorable for Chile, at least for 1984–85, because of the lag of copper prices from their normal response to the international cycle. I should also note that the projections are not favorable for Peru.

Broadly, these projections represent the fact that the 1983 base was much more favorable than had originally been anticipated. There is some offset because interest rates have been higher than originally expected and the dollar depreciation has been delayed, but there has been a favorable offset from stronger than expected OECD growth.

Other studies have tended to confirm this basically favorable outlook.[3] Morgan Guaranty has done a number of similar projections. The International Monetary Fund's most recent projections are quite similar to mine. There is a less favorable study by Enders and Mattione at the Brookings Institution, but the more unfavorable nature of that study hinges on the authors' adoption of very pessimistic estimates by Data Resources, Inc. for growth rates in the debtor countries themselves, especially Brazil and Mexico. The external projections of the Enders-Mattione study for those countries are not very different from mine.

The Inter-American Development Bank has considerably more pessimistic projections, suggesting extremely large potential deficits or else low domestic growth. However, it appears that the study used a rather low elasticity of exports with respect to OECD growth. The study does not take account of the beneficial effects of prospective dollar depreciation. And it assumes that imports will have to return rather substantially to their high levels relative to GNP of the 1980–81 period whereas it seems more likely that in certain key countries those imports were excessive as the result of overvalued exchange rates.

Let me address some specific criticisms that have been made of my model. In a paper for the Overseas Development Council,[4] Albert Fishlow suggests that my calculations are highly sensitive to macro assumptions. He makes a change in the assumption on terms of trade, assuming instead that there is no rise in terms of trade as OECD growth increases. He also assumes that there is no response of exports to real depreciation of the country's exchange rate. The first version of Fishlow's paper which was distributed to the press in June of 1984, indicated that under his alternative assumptions, the debt-export ratio, instead of declining from 1.88 to 1.28 as I had estimated for the oil-importing developing countries, would decline only from 1.88 to 1.71 by 1986. Fishlow concluded that small changes in the assumptions could virtually eliminate the improvement identified in the projections.

Unfortunately, Fishlow's initial calculation involved an error. The final published version of the Fishlow study corrected the calculation error, and showed accurately that under his alternative

---

[3] For details on alternative forecasts, see William R. Cline, International Debt: Systemic Risk and Policy Response, pp. 169–75.

[4] Albert Fishlow, "The Debt Crisis: Round Two Ahead?" in Richard E. Feinberg and Valeriana Kallab, eds., Adjustment Crisis in the Third World (Washington, DC: Overseas Development Council, 1984), pp. 31–58.

assumptions the debt/export ratio would decline from 1.88 in 1983 to 1.54 in 1986. However, the interpretative language in the final paper changed little. The thrust of Fishlow's argument remained that my model is highly sensitive to small changes in the assumptions, whereas to my mind, the decline in the debt-export ratio calculated by Fishlow (as corrected) is still substantial. Fishlow goes on to say that a 2 percent rise in the interest rate would eliminate one-fourth of even this improvement. But that impact should come as no surprise. A rise of interest rates by 8 percent would eliminate all the improvement, in Fishlow's scenario, but my own sensitivity analysis had already demonstrated that extreme increases in the interest rate such as this would eliminate the expected progress. The more fundamental point is surely that an 8 percent rise in interest rates above their still high level is highly unlikely.

Rudiger Dornbusch has also taken considerable issue with my model.[5] He criticizes its export elasticities as excessively optimistic. I have compared a number of elasticities of LDC exports with respect to OECD growth to examine this question. As shown in Table 1, my estimates are very much in the same field as most estimates of this relationship.

Some analysts appear to have been confused because my model uses a marginal elasticity of 3 but an average elasticity of 2. My estimate has a negative constant export growth term which pulls down the average. For example, at zero OECD growth, LDC export volume declines by 3 percent in my model, while at 3 percent OECD growth, these exports grow at 6 percent. One extra percentage point in OECD growth raises LDC export growth (volume) by 3 percentage points (marginal elasticity of 3), but at expected OECD growth of 3 percent, LDC export growth is only twice as fast as OECD growth (average elasticity of 2). And to make accurate comparisons to most of the other studies, the average elasticity in my model must be examined, not the marginal elasticity.

There is also a question whether my methodology overstates the recovery in terms of trade with respect to a change in OECD growth and here, Dornbusch's criticism fails to take account of the fact that my terms of trade estimate is a once-for-all effect, whereas his and most other estimates are of an ongoing effect. In my view an ongoing impact is probably a technical misspecification. For example, if there is 1 percent permanent growth in the OECD economies, the growth rate is so low that one certainly would not expect LDC terms of trade to improve from now into the infinite future. A preferable specification relates changes in LDC terms of trade to changes in OECD growth rates.

The difference in the specification means that one must examine the time period of analysis. When this is done accurately, and I suggest that for comparability the once-for-all terms of trade change in my model may be viewed as being phased in over five years, my combined estimate of terms of trade and export volume—what may be called the export revenue elasticity—turns out to be a value of 2.6, which is in the same range as recently esti-

[5] See references to table 1.

mated by Carlos Diaz-Alejandro (whose estimate ranges from 2.6 to 3.7) and others.[6]

On balance, it would not appear that my model overstates the favorable prospects for the developing countries when one properly evaluates the elasticities.

CONCEPTUAL ISSUES

Important conceptual issues are emerging at the present time. First, many in developing countries believe that it is unacceptable to have the outward transfer of resources that is an integral part of the projections I have made. The improvement in the debt-export ratio derives from the fact that interest payments coming out from the country are greater than the new borrowing being taken on by the country; interest payments exceed the capital inflows.

In my view, although technically this situation is an outward transfer of resources, it is essential if the developing countries are to restore their creditworthiness. If their borrowing is as large as their interest payments, there will be little decline in their debt-export ratios. Their debt will continue to escalate, and they will continually be at the mercy of the banks and others for financial emergency packages. In short, there will be no normalization of the situation. Moreover, based on the projections I have made, and taking account of import needs for satisfactory domestic growth in the debtor countries, it should be possible to achieve these substantial outward transfers of resources at the same time as achieving sufficient domestic growth for political viability.

A related question is whether import levels immediately before the debt crisis were bloated, largely because exchange rates were overvalued. For example, in Argentina the exchange rate had been used unsuccessfully as an anti-inflationary device and had become highly overvalued. The same thing occurred in Mexico. The abundance of foreign exchange from the oil bonanza in Mexico and Venezuela led to magnitudes of imports that were not really required for growth. There is detail in my book about the sustainability of recent import levels in these countries.[7] But in short, it seems to me that renewed growth should be possible without causing imports to mushroom back to their very high previous levels, so that a continued recession is not a prerequisite for debt management.

One other conceptual point warrants emphasis: the growing constraint of inflation. The emerging situation in Brazil and to a large degree in Argentina is that the external constraint is no longer the binding one. Inflation has become the binding constraint on growth. Brazil's inflation is over 200 percent a year; the figure for Argentina is over 700 percent.

In that environment, it becomes a great challenge to policymakers to reduce inflation without causing economic stagnation. Fiscal

---

[6] The average volume elasticity in my model is, as noted, 2.0. The terms of trade elasticity for a 1 percent rise in OECD growth, on average, is 1.5 in each of two years. Thus the revenue elasticity comparable to estimates by other authors is 3.5 for one year (volume 2, plus terms of trade 1.5). Over a five-year horizon the average revenue elasticity is 2.6 (volume 2, plus total terms of trade elasticity of 3 divided by 5 years).

[7] William R. Cline, International Debt, p. 161.

and monetary restraint can hardly be avoided in the face of such inflation, but there is always the risk that they will restrain growth as well. And if growth is restrained, recession will tend to be blamed on the debt crisis, because the political environment is one in which external debt is seen as the culprit.

POLICY IMPLICATIONS

Despite these caveats the central message of my analysis is that the evidence today corroborates the view that the debt problem can be managed on the basis of international recovery, expansion of exports, and a return to more normal creditworthiness. Where does this conclusion lead in terms of policy?

Although there are clear signs of economic improvement in the debt problem, the situation is still vulnerable on political grounds. When interest rates rose earlier this year, the Latin American debtor countries got together in the so-called Cartagena initiative, and if the interest rates had continued to rise, it is conceivable that this exercise could have become more aggressive. There is also political pressure from the very severe recession of 1983. The financial system is not out of the woods in terms of the political vulnerability of the debt crisis.

Accordingly, policy measures must be considered. It is insufficient simply to assume that the situation will take care of itself. I would include on the policy agenda an expansion of World Bank capital. I would also include expansion of other lending such as export credit through the Export-Import Bank and other national agencies. In the private sector, it is especially important that the banks themselves not truncate lending any further than they already have. Their new lending needs to continue at a level somewhere on the order of $20 to $25 billion a year, down from about $50 billion in 1981.

It is essential that macro policies in industrial countries permit achievement of the critical growth threshold—I would say somewhere on the order of 2.5 percent—in the industrial countries, since growth in these countries is the motor force in recovery from the debt problem. One of the most important measures would be for the United States to reduce its fiscal deficit and relax monetary policy so that there would be less pressure on interest rates and greater chance of sustained growth. This correction in the policy mix would have a direct benefit for the debtor countries by reducing their interest burden, and an indirect benefit by reducing the overvaluation of the dollar.

There are also negative recommendations. Policymakers should avoid the sweeping debt reform schemes that would have a new international agency take over the debt and write it down substantially. They should also resist proposals, for example, that the developing countries pay no more than 8 to 10 percent interest and make the banks forgive the difference. If such a scheme of partial interest forgiveness were adopted, the growth effects for the debtor countries would be minor—somewhere in the range of a 1 to 2 percent once-for-all rise in GNP—and yet the damage to the credit rating would be severe and lasting, and the damage to banks would be severe. Similarly, proposals to limit service to a specific fraction

of export earnings have the same kind of drawbacks. Typically their advocates forget that the net gains would be small because there would be a drying up of new borrowing.

Perhaps one of the most encouraging signs is the package of measures that the banks themselves have recently adopted. In September, the banks gave to Mexico a multi-year rescheduling which reduced the spread on the interest rate, reduced the interest base from US prime to cheaper LIBOR, and essentially consolidated the prospects for Mexican recovery and dealt with the possible problem of very high levels of amortization in coming years. It is important that this kind of a package be extended to other debtor countries where possible and especially where justified by improved external sector performance. I would expect Brazil to be a logical candidate for such a package soon.

It would also be desirable for the banks to move in the direction of extending what I call the reimbursable interest averaging cap (RIAC). This loan instrument would specify a particular interest rate based on the current market rate and provide that if interest rates surge above that level, the excess would be deferred until interest rates once again decline. At that point any deferred amounts would be reimbursed. Such loans could be introduced voluntarily by the banks, perhaps charging some additional spread for the service. Banks could take care of their accounting problems by insuring the amount of interest deferred so that they could continue to accrue income. This approach would help insure against one of the main risks in the system now: the possibility of a large rise in the interest rate.

A corresponding effort should be made in the public sector by the creation in the International Monetary Fund of a compensatory finance facility for interest rate surges, conceptually comparable to compensatory finance for fluctuations in export earnings. Such a mechanism should be structured such that it only deals with net changes. For example, in 1984, when interest rates rose but the benefits of export growth associated with higher OECD growth were even greater, such a facility would not necessarily have extended additional credit. If, on the other hand, there were no offsets, such additional credit could be extended. An IMF interest facility would also contribute to reduction of a major vulnerability in the system, the risk of sharp rises in interest rates.

Finally, industrial countries must follow trade policies that make it possible for the debtor countries to service their debt. It is essential to avoid new protection against exports from these countries. It was encouraging to see that President Reagan rejected proposals for protection in copper. It was discouraging to see the way the steel sector seems to be turning into an international cartel which will restrict exports not only from Europe and Japan but also from the debtor countries.

TABLE 1.—ELASTICITY OF EXPORTS FROM DEVELOPING COUNTRIES WITH RESPECT TO INDUSTRIAL COUNTRY GROWTH

Study	Export concept	Countries	Elasticity
Cline, 1983	volume	non-oil LDC's	marginal: 3.0
	do	do	average: 2.0 [1]
	revenue [2]	do	1-year: 3.5 [3]
	do	do	5-year: 2.6 [3]
Federal Reserve 1983	volume	do	average: 1.7
Morgan Guaranty 1983	do	do	average: 3.0
Fishlow, 1984	do	do	marginal: 1.1
	do	oil importers	marginal: 1.7
	do	do	average: 2.2 [4]
	do	Brazil [4]	marginal: 1.8
	do	do	average: 3.8 [1]
IMF, 1984	do	non-oil LDC's	average: 2.0
IDB, 1984	do	Latin America	short-term: 1
	do	do	long-term: 1.5
Dornbusch, 1984	do	non-oil LDC's	marginal: 0.75 [5]
Dornbusch/Fischer 1984	do	do	marginal: 1.15
Do.	revenue [3]	do	marginal: 2.0
Diaz-Alejandro 1984	do [2]	Argentina, Brazil	marginal: 2.6 to 3.7

Note:
[1] Evaluated at OECD growth = 3 percent.
[2] Incorporates terms of trade.
[3] One-time rise from acceleration of OECD growth: terms of trade elasticity of 3 over two years.
[4] Non-coffee.
[5] Growth variable in OECD industrial output, which itself has a nigh elasticity with respect to OECD GNP.
Sources:
William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, POLICY ANALYSES IN INTERNATIONAL ECONOMICS No. 4, September 1983.
Ronald Leven and David L. Roberts, "Latin America's Prospects for Recovery," Federal Reserve Bank of New York, Quarterly Review, vol. 8, no. 3 (Autumn 1983), pp. 6–13.
Morgan Guaranty Bank, "Global Debt: Assessment and Long-Term Strategy," World Financial Markets (June 1983), pp. 1–15.
Albert Fishlow, "Coping with the Creeping Crisis of Debt," University of California, Berkeley, February 1984, mimeographed, Appendix table A.
International Monetary Fund, World Economic Outlook, 1984, chapter 4.
Inter-American Development Bank, External Debt and Economic Development in Latin America (Washington, DC, 1984).
Rudiger Dornbusch, "The Effects of OECD Macroeconomic Policies on Non-oil LDCs: A Review," (Cambridge, MA: MIT, mimeographed, September 1984).
Rudiger Dornbusch and Stanley Fischer, "The World Debt Problem," report prepared for the UNDP/UNCTAD and the group of Twenty-four, mimeographed, July 1984.
Carlos Diaz-Alejandro, "In Toto, I Don't Think we are in Kansas Anymore", prepared for Brookings Panel on Economic Activity, September 13–14, 1984.

CRITIQUE OF CLINE'S ANALYSIS

Mr. REIFMAN. Thank you, Bill. That was a fine review of the present and look ahead. Your reasoned optimism can be contagious. However, such optimism has not spread to Rudy Dornbusch [1] or Tom Enders and Rich Mattione.[2] Their estimates are more pessimistic than Bill's. How does the panel feel about this? Richard Feinberg, of the Overseas Development Council.

Mr. FEINBERG. Well, Al asked me to prepare a short response to Bill. Bill brings good cheer to all of us and sometimes I feel like saying, why not? We all like good cheer. Particularly, Americans like good cheer. After the recent elections, I personally feel the need for good cheer.

I would not deny that there has been considerable progress on the debt issue. Clearly there has been, but I would argue that we

[1] Dornbusch, Rudiger, and Stanley Fischer. The World Debt Problem. Manuscript for Studies on International Monetary and Financial Issues for the Developing Countries. report to the group of 24. UNDP/UNCTAD. September 1984.
[2] Enders, Thomas O. and Richard P. Mattione. Latin America: The Crisis of Debt and Growth, Brookings Discussion Paper in International Economics. December 1983.

are not out of the woods yet. Problems remain and some of the projections could be sensitive to a number of variables that may not work out as well as we might hope.

I would just like to lay out a few of the issues which we will probably want to discuss through the course of the day.

As Bill has stated, the OECD growth rate is the most important assumption. It has to be at 2.5 to 3 percent. All the models have that and the obvious question is how long can the United States economy sustain our twin deficits. Is the United States an immortal economy where we can virtually do whatever we want regardless of the international repercussions or will there be a day of reckoning?

On the question of the elasticity of export revenues with respect to OECD income, Bill pointed out there may be some misimpressions conveyed in the Fishlow thesis that the Overseas Development Council [3] published. Nevertheless, the basic point remains that Cline's calculations are very sensitive to certain basic assumptions.

With regards to the terms of trade, for example, some commodity prices are more sluggish than one might have anticipated, particularly in certain key commodities that are very important to certain countries, and Bill mentioned copper.

To a certain extent one has to disaggregate and where things may be looking relatively good for the manufacturing exporters such as Brazil and Mexico, they don't look so good for many of the countries who are commodity exporters.

Then there is the question of the dollar. Bill and most people have projected that the dollar would have already started to fall. It hasn't. And there's the additional question of not only will it fall, but if it does fall, what will be the impact of the devaluation on LDC export earnings. And the Fishlow argument indicates that the impact will not be as favorable as Bill and others have projected.

Then there's the question of the supply side, the ability of the LDCs to export to meet the potential increase in demand. To a large extent, what you have in a number of key countries is not the operation of new export industries. Rather, firms that have been producing for the domestic market, found that domestic market dried up as a result of internal recession, and they simply switched their production to the external market. That, to a certain extent, is a once and for all shot in the arm, not necessarily something that can be followed up on.

So we have yet to see whether or not the LDCs will be able to put in place in the current situation of capital shortage and domestic recession the new investment they will need to continue that export growth even if we have a favorable external environment.

Then, of course, there is the question of protectionism, potential protectionism. Now actually the United States I would say has been doing relatively well, considering the large trade deficit we have. On the other hand, the Europeans are not doing so well. If you look at recent LDC exports trends, it's the U.S. market which is garnering the large bulk and Europe is not looking very good.

---

[3] Feinberg, Richard E. and Valerianna Kallab (editors). Adjustment Crisis in the Third World, pp. 31-58. Overseas Development Council, and Transactions Books, Washington, D.C. 1984.

So if you were to get a switch in the mix of growth rates with the Europeans growing somewhat faster and the United States slowing down, the implications for LDC exports are worrisome being that the European market seems to be more protectionist.

Then there's the question of interest rates. Again, they remain higher than we have anticipated although they have fallen somewhat now, but the duration of this decline is uncertain.

To a certain extent, I think one could say that the optimistic projections have in some respects been right but for the wrong reasons. The OECD growth rate has remained stronger than anticipated, but dollar devaluation, interest rates have been in fact less favorable than anticipated.

In the wash, serendipitously, the situation has come out okay, but in the basic models projections have been considerably off in all the key areas which should lead one to worry somewhat about the value of the projections for the future.

Then there's the point that Bill [Cline] did very nicely emphasize, that is, whether or not the LDCs, particularly Latin America, can continue to compress their import demand even if they resume growth. Here, the Inter-American Development Bank, among others, are less optimistic. They see a resumption of growth producing an increase in imports larger than those that Bill and others project.

One also has to wonder about the impact of renewed growth in the LDCs on exports, and whether those firms that have switched from the domestic market to the external market will come back again to the domestic market. This "reswitching" may occur particularly in the case of Mexico where firms have really only seen the external market as a market to dump their surplus.

I should add that it seems to me that this idea of compressing exports below historical trends raises questions about the development strategy that one is talking about. It seems to me that one in fact is talking about a major alteration in development strategies, which is something one might want to think about.

Also, it seems to me that the issue of domestic inflation that Bill mentioned is not unrelated to the external account. It's partly the result of devaluations and of the trade surpluses themselves which after all have a certain inflationary kick to them.

All of these come together ultimately on the question of the debt-service ratio. Even the drop in the debt-service ratio that Bill projects still leaves a pretty high debt-service ratio, i.e. clearly everybody is recognizing at this point that we have a long-term problem here depsite the progress made recently. In fact, interest rates may be a little higher than anticipated and import propensities may be a little greater than anticipated and export growth a little more sluggish than anticipated and you could have high debt-service ratios, still with some drop I think everybody concedes, but still pretty high by any historic trends.

Then the political problems. I would put them slightly differently. I think you've got, as Bill suggested, a continuing net capital outflow in the sense that interest payments are for some countries considerably in excess of net capital inflow from the commercial banking system. This appears increasingly not to be a temporary phenomenon but something which is likely to continue for the rest

of this decade. In fact, this could even get wider if the interest rates remain high and net new bank lending, in fact, this year new lending is running considerably below the expected 7 percent increase.

So on the one hand, you've got this net outflow and, on the other hand, you have restricted incomes and incomes, by the way, in the LDCs which will expand less rapidly than GNP growth precisely because you have this net capital transfer abroad. So you have not only relatively low GNP growth throughout the 1980s as Bill said, but domestic income levels and purchasing power within LDCs will remain even below that level. So you've got net capital outflows at the same time that you've got low domestic income and, of course, the average person in the LDCs immediately thinks, well, their income is being kept low while they're pumping all this money into the international financial sector.

To the extent that that situation gradually appears to be not a short-term problem but something that's going to persist, it could very well give rise to new political pressures.

Again, the point of all this is not to deny the progress that has been made, but there are some serious problems.

I would just conclude by pointing out, though, in terms of policy suggestions or prescriptions, it seems to me there is quite a degree of agreement among the optimists and those people who raise concerns that we're not yet out of the woods.

Everyone seems to agree that we need a different monetary and fiscal mix in the United States; and that there should be perhaps some interest rate concessions either unilaterally on the part of the banks as you had in the Mexican rescheduling, possible interest rate caps, compensatory financing facilities expansion, something along those lines to at least put some flexibility in the system if interest rates should go back up again. That could lead to unsure increased capital flows. The public sector itself has already begun to play a much larger role in international finance than was the case a few years ago, and the public sector has to remain active, both in terms of official financing itself or of providing incentives for private sector lending, incentives, for example, in terms of an expanded World Bank which tries to set a structural adjustment format which makes a country more creditworthy or whether we're talking about export credit guarantees of the Export-Import Bank, etc.

I might point out, though, that currently private flows last year and this year are running well below I think what the models would suggest is necessary. Commercial bank lending from the U.S. is virtually zero now, new lending to the LDCs during the first half of this year. Direct foreign investment flows, although the figures are very poor, are also quite low and a lot of people question whether or not there is a real potential for a major increase in direct foreign investment. So that even if one takes a relatively optimistic assessment of this problem, there is still clearly a full policy agenda out there for policymakers to implement.

Mr. REIFMAN. Thank you. That reminds me of what the physicist Niels Bohr said: "Forecasting is very difficult, especially about the future." [Laughter.]

Any other comments on Bill's paper, particularly the projections?

INFLATION

Ms. MORR. I have a question for Mr. Cline. You said inflation was a constraint. Do you use any inflation projections to go with the 4 percent growth? Do you assume that the countries will get this under control?

Mr. CLINE. My models do not incorporate domestic inflation in the debtor country, so that inflation is only lurking in the background. It's something that could impose a constraint that could keep their potential growth from being as high as it might be if you looked solely at the external constraint.

Mr. REIFMAN. Jeff?

Mr. FRANKEL. What exactly does that mean? I mean, without saying that inflation isn't a problem, in what sense is inflation acting as a constraint?

Mr. CLINE. There's a short-term and a long-term problem. Any cross-country or within-country over time analysis would suggest that inflation rates of 200 percent or higher is associated with very low growth rates. I've recently written a paper documenting that. That's the long-run problem. So I don't think it's plausible to say that Brazil can manage its problem by simply accepting 200 percent a year inflation from here on out and going for broke in terms of growth.

Then the shortrun question is, is it possible to do economic engineering, financial engineering, so that you can reduce the inflation rate satisfactorily at no cost in growth. And while I think it is true that you probably can bring inflation down quite sharply at relatively little cost in growth in the transition period, nonetheless, the direction of the policy variables to deal with that kind of inflation will be fiscal-monetary restraint and you certainly don't expect fiscal-monetary restraint in the short run to raise the growth rate. If anything, it tends to reduce it.

So it's in that sense that I'm saying that the near hyperinflation could be a near-term constraint that would reduce the growth rate below what it would otherwise be.

Mr. FRANKEL. The need to prevent inflation accelerating by restraint is helping keep inflation down?

Mr. CLINE. I would say even if inflation remains constant. I don't think you could talk plausibly about a constant 200 percent inflation with perfect expectations unchanged. For that reason, high inflation affects long-run growth. Here is a need to reduce it from high levels because they cannot credibly be maintained at stable, constant levels that might hypothetically avoid distortions to investment and growth.

Mr. REIFMAN. Walter.

POLITICAL CONSIDERATIONS

Mr. EUBANK. In your discussion you mentioned the term political viability several times, suggesting that it is an important element in your model. It sounds like the ultimate constraint within which all solutions to the external debt problem must be found. However,

it seems to me that this variable is quite different in each country and would defy aggregation. For example, Argentina is quite different from Mexico. In your model how do you deal with the variability of political viability across countries?

Mr. CLINE. I don't and that again is very much ex-model although my book has some country appendices and does have a chapter on political viability that discusses it in a qualitative sense.

I emphasize the fact that the Mexican political system is much more resiliant than a lot of people were predicting. They have accepted fairly sharp cuts in real wages. That has to do a lot with the way the official party, the PRI, is organized on sort of a coopting basis whereby it tends to absorb criticism and provides some benefits for the critics and essentially neutralize them.

In Argentina, I think in the long run the diagnosis I have in my book will prove right. The election of Alfonsin is a very favorable development, even given tremendous delays on debt policy on the last year. The politics remain an uncertainty, but I think the basic economic determinant of political viability is essentially the growth rate and, more fundamentally, the growth of absorption of consumption and investment, and when you project those in the future, you see those at substantial levels—4.5 percent of GNP and even higher for absorption now, because the once-for-all reduction to outward transfer of resources has already taken place and so you're reducing the relative weight of that outward transfer of resources over time.

I think the feasible growth is compatible with political stability.

Mr. EUBANKS. My problems with the idea of political viability are how to measure it, how to incorporate it into econometric models such as yours, and how to recognize the differences across countries. Until we can clearly establish this critical link between politics and economics in the developing countries, the concept will remain an important idea in our minds, but gives us little insight into the problem at hand.

Mr. CLINE. Does not the transfer of LDC resources to the industrial countries create a political problem? The outward transfer of resources is technically not an outward transfer of capital because principal coming in still exceeds principal going out. In fact, no principal is going out because there are essentially reschedulings. So technically it's transfer of resources outward.

There is a tendency to say if resources are transferred abroad they aren't available at home. But that's a misconception because most of these economies are operating well below capacity and in fact the export expansion which is the essence of an outward transfer of resources—your exports are larger than imports—this export expansion is the leading sector in growth now. That's precisely where growth is occurring in Brazil and Mexico.

So I come back to the fact that it's the growth rate that's going to matter. You're not going to get the man in the street in Brazil picking up the newspaper, finding on page 38 that the resource transfer is a minus 4 percent of GNP, and starting a revolution. However, he is going to be asking does he have a job, does he have something to eat, and that's driven by growth.

THE VALIDITY OF CLINE'S FORECASTS

Mr. REIFMAN. Mr. Espinosa-Carranza is from the Inter-American Development Bank and he's done a forecast for his book which is a little more pessimistic than Bill's. Did you want to make a comment?

Mr. ESPINOSA-CARRANZA. Thank ycu Mr. Chairman. The question here is not a matter of pessimism or optimism, otherwise I would like to share your optimism, Mr. Cline. Also, I would suggest that we are not out of line in terms of projections. Anyway, I should confess that, in general, I do not feel fully confident about this type of macroeconomic projections. Very soon, at the end of 1984, we will be able to judge how close to reality had become the predictions made the year before.

EXPORT TRENDS AND PROSPECTS

With respect to exports, which Mr. Cline says it is a very important factor in determining a potential debt problem, we at the Interamerican Development Bank projected its value in current dollars to increase 9 per cent in 1984 and 13 per cent in 1985.[1] Latin American exports to United States have been growing during the first nine months of 1984 at the rate of 20 per cent,[2] in comparison with the same period of 1983. At the same time, Latin American exports to European and Asian countries, according to provisional data, showed no increase at all or even a decrease. Given this data, I would feel confident with an export growth for the whole year 1984 in the range of 9 to something up to 12 per cent.

The most striking element in this scenario has been the extraordinary increase this year in Brazilian exports to the United States, in the order of 57 per cent. Also, Mexico expanded its exports to the United States at the rate of 9 per cent. This is a significant growth, because it is superimposed to the increment shown in 1983, which was in the order of 8 per cent. But at the same time, there are four countries in Latin America that decreased the value of their exports to the United States market during 1984: Bahamas (−22 per cent), Bolivia (−5 per cent), Chile (−21 per cent) and Nicaragua (−41 per cent).

Nevertheless, my concern is related with the prospects of United States imports in the near future. In my view there are reasons to expect a certain slowdown in imports growth. First, 1984 has been an exceptional mark in the imports records of the United States, similar only to the figures in 1950 and 1974.[3] Second, the new protectionism, particularly withr espect to steel products and copper, will adversely affect the products of some of the larger debtor countries. Third, the growth recession of the American economy beginning in the second semester of 1984 is expected to weaken global demand for imported goods.

So, there is not a point to say that our projections are pessimistic. The real concern is related with the potential risks of a slow-

---

[1] Inter-American Development Bank. External Debt and Economic Development in Latin America. Background and Propsects. Washington, D.C., January 1984. Page 46.
[2] U.S. Department of Commerce, Highlights of US Trade. FT-155.
[3] Economic Report of the President. February 1984. Page 332, Table B-99.

down in the rate of growth of demand for imports in the United States.

INTERNATIONAL INTEREST RATES

The international interest rates are also a crucial exogeneous variable that affects the outlook of the debtor countries in Latin America. In the study prepared at the Bank, we assumed an average interest rate equal to 11 per cent a year.[4] This is a figure very close to the observed LIBOR rate during the first nine months of 1984, which averaged 11.2 per cent.[5]

IMPORTS AND ECONOMIC GROWTH

With respect to imports by Latin American countries. A third import variable in determining the economic recovery and the balance of payments position—I fully agree with Mr. Cline on the need to increase their volume. But here the questions are what imports? and how much more of them? the answers depend upon the pattern of development to be implemented by Latin American countries.

I agree with your assumptions on the parallel between the rise of imports and the condition with respect to the growth of Latin American countries, but the real question there is about the pattern of development in the coming years in Latin American countries.

Mr. REIFMAN. Thank you. Jamie Galbraith.

Mr. GALBRAITH. I have a question based upon my own ability to become gloomier and gloomier as I listened to the proceedings. That seems to be based on two things. One, your model, as I understand it, is essentially directed to the question of whether the debt crisis will remain manageable, which is somewhat analogous to the question of whether we can avoid a nuclear exchange, which is to say it's an important but on the whole rather modest criteria for progress.

Your optimism on that score seems to require, if I heard you correctly, at least six criteria falling into place which I believe to be essentially exogenous, and they are: depreciation of the dollar, more private lending, more public lending, continued sustained OECD growth, deficit reduction in the United States, and no major dramatic increase in protectionism, and there may be some others there as well.

My question is, if I disagree with you or if I feel gloomier than you do on the likelihood of four or even six, would I be justified in reading your model as having gloomier results than you do?

Mr. REIFMAN. Bill Cline has an answer to this.

Mr. CLINE. Let me address some questions that are left hanging from Richard Feinberg and Mr. Espinosa-Carranza and from Jamie Galbraith.

Basically, the first one really ties to what Jamie just said, concerning the fact that the model has several variables and the risk that they might not all turn out right. At least Richard is now

[4] Inter-American Development Bank. O. cit., page 71.
[5] IMF. International Financial Statistics. October 1984.

saying I was right but he still qualifies it by saying but for the wrong reasons. I'll take the first, "I was right." I'll take anything I can get. But I would like to make a methodological point. The results of a forecasting model depend on its internal parameters and on the exogenous factors that are assumed. Richard and Jamie are saying that some of the exogenous factors erred in one direction and some erred in another direction. I think in a sense that this outcome is a verification that the model is a pretty good one, or at least the assumptions were pretty good. If you think of any random process, it is going to have an error distribution around the mean. In a statistical and probabilistic sense, if some of the variables are distributed on one side of the mean and other variables are distributed on the other side of the mean, the consequence is that the central outcome of the model is more or less what is predicted at the mean, then it seems to me that that's successful forecasting.

Suppose a model has five variables in it. The probability of getting every single variable exactly on the dot is very, very small. So basically what you want to do in a forecasting model is see that its internal structure is not such that it has a sort of systematic bias so that with a random distribution of errors from the projected variables it would give a biased outcome.

So I guess I would say that I think the fact that the model holds up when the unexpected strength of the growth rate offsets the excessive interest rate and the overly strong dollar is somewhat of a strength rather than a weakness of the model.

There were some allusions of how the export growth to the United States could deteriorate if the dollar comes down. I think that comment fails to recognize that if the dollar comes down, there will be a shift in the destination of LDC exports from the United States toward Europe and Japan, but there should be no change in the total value of those exports.

In particular, if the countries are pegging their real exchange rates on a trade-weighted basket and if the elasticities are symmetrical, then any change in the exchange rate between the dollar and the yen and mark will simply alter the destination of the country's exports and not alter the quantity.

That means that the only impact of the dollar depreciation is the financial rather than the trade volume impact and, clearly, that will be beneficial because it will boost dollar prices of traded goods while the dollar denominated debt remains unchanged in nominal dollar terms.

Both Richard Feinberg and Jorge Espinosa-Carranza said, can we have the structural changes associated with these lower import ratios. We are seeing sharp structural changes. Brazil has reduced its oil import bill from $10 billion to about $5 billion on a net basis by increasing its domestic production of oil by over 40 percent. Similarly, Brazil used to import several million tons of steel. It now exports several million tons of steel. A lot of the decisions on import substitution made in the '70s in Brazil are now coming to fruition and are helping out in this process.

For Mexico and Venezuela, I took real imports and compared them with real GNP over the last 20 years and '83 was below the lowest quartile of that distribution. So I said, okay, suppose in the future you have to return to that lowest quartile or quintile but

that that's sufficient. Well, that return would cause Venezuela and Mexico's imports to rebound by about 30 percent and that's what I've incorporated in my model. So I'm allowing for return to what I think are plausible levels of real imports. I'm simply saying that they don't have to go all the way back to their historic highs in 1980–81.

Jamie Galbraith's question, what if he doesn't think the dollar is going to come down—well, I've got a simulation in the model that says, okay, if the dollar only comes off by 4 percent in '85 and another 4 percent in '86, which is what DRI and Morgan are projecting, it doesn't affect—by the way, that's the real interest differential so that's what some people would say is the expected rate of depreciation—it doesn't affect the basic outcome very much. It means progress is not as great, but it doesn't affect it all that much.

I did not assume that there would be more bank lending and that there would be more public lending. That's not a prerequisite of my model. I think it would facilitate the situation. I advocate it as a policy measure as an insurance policy, but the model in fact has the current account deficit in major debtor countries remaining sort of frozen at $30 to $40 billion. So that's not at all a prerequisite.

OECD growth, yes, is crucial. I've not done a revised critical threshold, which I hope to do with the new data base. I think it's going to be somewhat lower than 2.5 percent. It may be in the range of 2 percent because the '83 base was so much more favorable than anybody expected and what my model expected.

I don't see why we can't achieve 2.5 percent growth in the OECD over an extended period of time and I do allow for some growth recession. But, look, we had 4 percent growth in this country in the '50s and '60s. We no longer have the key element in the '70s that contributed to global recession which is the stagflation consequences of two oil stocks. In fact, we have benefits from oil, a reduction in the price of oil. So we don't have that dilemma posed to policymakers, and I don't see why we at least can't return somewhat closer to the 4 percent of the '50s and '60s.

There's a lot of talk about how Europe cannot do so because the early post-war period was an unusual period, they were borrowing technology from us, et cetera, creating the Common Market, and there's now Eurosclerosis—real wages are too high and the economies can't grow. Nonetheless, it seems to me that growth rates of 2.5 percent are perfectly plausible for Europe.

Japan, although it's had high growth rates in the past, seems to me ought to be able to grow at 4 to 5 percent.

So I think it should not be difficult for OECD growth to surpass the threshold of 2.5 percent or certainly 2 percent. But you're right, if you don't buy that, if you think OECD growth is going to be 1 percent or zero percent, then you have to reach the pessimistic conclusion. And that is the most important one where you opinion should differ from this conclusion if you differ in your assumption about the underlying economic environment.

I do not assume that the U.S. deficit will come down. I am again saying it would be a very favorable policy measure, but I built in fairly high interest rates in my projections. It's not clear how much

of an impact reduction in the U.S. deficit would have on growth because, you would have the contractionary effect of less fiscal stimulus offset by the expansionary effects of lower interest rates. I do think in the longer run growth would be relatively more balanced, but I am not assuming a decline in the deficit even though I think there will be some.

Mr. GALBRAITH. But we cleared up the distinction between something that is a prerequisite and something that would just be helpful.

Mr. CLINE. Yes.

Mr. FRANKEL. Could I ask a question on this disagreement between you and Rudy Dornbush on the theory of should the rate of growth in terms of trade depend on the rate of growth of OECD output or the rate of change of the rate of growth in OECD output?

In theory, you're saying it should depend on the rate of change.

Mr. CLINE. Yes.

Mr. FRANKEL. What's the rationale for that?

Mr. CLINE. Suppose the OECD grows at 0.1 percent from now for the next two decades. It would be one-tenth of one percent a year for the next two decades. I can assure you that under those circumstances you're not going to have rising LDC terms of trade. You will probably have declining terms of trade.

Again, it's like the critical threshold of the whole debt picture. There's a normal historic growth rate for the OECD at which OECD terms of trade tend to be constant and I peg that somewhere in the range of maybe 2 to 3 percent. The specification for this model where the terms of trade are strictly linear with respect to the OECD growth rate doesn't take that into account. If you have constant OECD growth at 2 or 3 percent, it would be unrealistic to expect a secular increase in terms of trade of the LDCs.

Mr. FRANKEL. If the growth rate is zero or very low in terms of trade or actually deteriorating, you would have to get up to a certain level of OECD growth just to keep even, but that's different from saying that the rate of improvement in terms of trade depends on the second derivative of GNP rather than the first.

Mr. CLINE. I don't think it is.

Mr. REIFMAN. Second derivatives can wait.

Larry Sjaastad.

Mr. SJAASTAD. In some sense I find this discussion a little amusing because it's based on the premise that the debt is going to be repaid.

Mr. CLINE. No, I object.

Mr. SJAASTAD. The servicing is going to be.

Mr. CLINE. Yes.

Mr. SJAASTAD. The lenders don't operate under that assumption. We all know that there will be enormous discounts.

Mr. CLINE. Would you like me to comment on that point?

Mr. SJAASTAD. Yes.

Mr. CLINE. OK. Jeff Sachs and a colleague have just estimated that bank stocks are valuing LDC debt of the five major Latin American debtors at 79 cents on the dollar, so that's a floor on the discount.

Number two, that's a depressed price because there are banks that have an incentive to get rid of their debt even at fire sale

prices. A regional bank that can say that it has no LDC debt on its books can get cheaper funding in terms of certificates of deposit and it can get a better quotation on the stock market. The stock market is not sufficiently finely discriminating that it knows exactly what the bank's exposure is. It's not published anywhere. So some of those banks are prepared almost to give away their LDC debt because it would improve their funding and their stock market valuation.

Number three, it's a very thin market. You would expect that in times of distress that you would have in some sense a lower price than the long-term expected value.

I completely disagree with those people who say that the debt crisis has caused a large loss, it's time to face up to it and the only question is how to divide that loss between the banks, the public and the country. I think that's a misdiagnosis. It essentially is a diagnosis, at least in some sense, of insolvency.

So I don't think the fact that you find some debt trading in the market at 79 cents on the dollar means that this whole approach is wrong.

Mr. REIFMAN. Well, there's a lot more to talk about here but we've used Bill long and well. I'm reminded of something that happened when I was just starting out. I brought in a report that proved something to the Ambassador and there wasn't any controversy about it. It was clear and he didn't like the answer and he said, "I want facts, not figures." [Laughter.]

Let's take a 10-minute break and have coffee and then we'll come back and hear from the representatives of Latin American countries on how they view the problem.

[A brief recess was taken.]

Mr. REIFMAN. Now we are going to hear what the debt problem looks like from two of the debtor countries' point of views. Speaking for a large debtor, Brazil, we have Sergio Amaral of the Brazilian Embassy.

A VIEW FROM A LARGE COUNTRY: BRAZIL—BY SERGIO AMARAL, FINANCIAL COUNSELOR, BRAZILIAN EMBASSY

Mr. AMARAL. From the 1982 to the 1984 IMF/World Bank annual meeting there was a significant change in the perception of the world debt crisis. In 1982, the atmosphere was one of apprehension. The prospect of a disruption of the international financial system was not to be excluded. In 1984, apprehension had given way to some relief. The much feared disruption had been avoided and some progress had been made in dealing with the debt. The so-called debt strategy is now moving from a short-term to a medium-term approach. The question now is whether the institutional framework and the procedures designed to deal with the debt problem are appropriate to ensure a definite way out of the crisis.

The purpose of these remarks is to discuss some aspects of the debt problem from the point of view of a debtor country, in this case, Brazil. Three main questions will be focused: first, the Brazilian adjustment process; second, some traits of the so-called debt strategy; and, finally, medium-term prospects.

43-427 O - 85 - 2

A. BRAZIL'S ECONOMIC ADJUSTMENT

The adjustment program adopted since 1982, in agreement with the IMF, is beginning to yield positive results. As a matter of fact, at the end of the first half of 1984, Brazil was exceeding the targets in all performance criteria agreed upon with the IMF, such as public sector borrowing, domestic assets, balance of payments, and growth of the foreign debt.

On the external front, the outstanding result is the trade balance. Since March, monthly surpluses have exceeded one billion dollars. By early September, the original $9.1 billion target for the whole year had already been reached. Exports are rising at an annual rate of 25% and imports are dropping at a rate of 10%. This opens the prospect of a 1984 surplus in the range of $12 billion, almost double the already remarkable 1983 figure of $6.5 billion. These results have allowed the Government to start liberalizing imports, a step much awaited by both the Brazilian private sector and its trading partners.

The current account deficit, which had reached almost $15 billion in 1982, dropped to $6.2 billion in 1983. The forecast for this year was a further reduction to $5 billion. Trade balance results, however, should bring it down to around $2 billion, a cut of over 80% in only two years. The cashflow situation has been normalized since March and all arrears were paid in the first half of the year. By the end of June, international reserves (IMF concept) closed at $7.5 billion—a jump from the December 1983 figure of $4.5 billion—and could exceed $9 billion by next December. The debt service/exports ratio, which climbed to 97% in 1982, is now estimated to be down to 73%.

On the domestic front, important reforms have been undertaken:

(a) Subsidies have been eliminated or, at least, substantially reduced;

(b) Wage adjustments have been partially deindexed;

(c) Public expenditures have been drastically cut: the operational deficit of the public sector, as a percentage of GNP, fell from 6.6% in 1982 to 2.5% in 1983. In 1984, the goal is to eliminate the deficit altogether and even turn in a small surplus;

(d) A tight monetary policy is in place, aimed at holding the expansion of monetary aggregates well below inflation. In 1983, the money supply grew 92%, while inflation ran at 211%. In 1984, the goal is to contain the monetary case to 95%, in spite of the monetary impact of the higher than expected accumulation of international reserves.

Conditions for economic growth have improved. For the first time in four years Brazil's GNP will experience some growth rate. By August industrial production had grown by 6% and, by year's end is expected to show an 8% increase. GNP growth might thus be around 3%, which represents a valuable turnaround from the gloomy picture of 1982/83.

Inflation remains the nagging problem. Despite all anti-inflationary measures adopted, inflation leveled at 220%. It has even increased slightly in the last month. This is partly the result of the corrective measures introduced to adjust the economy, such as the elimination of subsidies and the exchange rate policy; but it is also

due to the overall indexation of the economy. Inflation is now the object of a lively debate in Brazil. Some argue that, had it not been for the adjustment policies, inflation could have been kept down at the 100% level. What seems most likely is that, while indexation prevents inflation from falling, corrective measures actually bring it up.

Structural adjustments also deserve to be mentioned. After the first oil shock, the Government faced a dilemma: either drastically cut oil imports and fall into deep recession—for Brazil used to import almost 80% of its oil requirements—or gradually adjust, making the best of the available resources in the international market. As is well known, the latter option was chosen and three priority sectors were elected: energy substitution, to reduce external dependence; exports promotion, to reduce trade deficits; and agriculture as a means of fighting inflation, generating exportable surpluses, and maintaining employment levels.

This adjustment strategy proved to be correct. Four years later, trade accounts had already shown a surplus. Agricultural production has grown almost 40% in the last decade. The energy structure has undergone a profound transformation, which can be illustrated by the fact that oil imports declined from $10 billion in 1982 to $8.2 billion in 1983 and to an estimated $6 billion in 1984. This reflects the massive investments in the development of the energy sector over the last ten years, with results such as:

(a) Domestic oil production, which was 175,000 barrels/day in 1979, exceeded 500,000 barrels/day this year, a target previously set for the end of 1985. Brazil is today Latin America's third larget oil producer, after Mexico and Venezuela. It is still its largest oil consumer, but it now produces 50% of its needs, instead of only 20%, as was the case a few years ago;

(b) Fuel production from sugar cane was 80 million gallons in 1973; today it runs around 2.5 billion gallons or the equivalent of 145,000 barrels of oil per day. Simultaneously, the development of new technologies and new products, better adapted to the changing profile of the energy supply, made possible the fact that more than 80% of new passenger cars produced in Brazil today are fully powered by alcohol.

(c) The impressive development of hydroelectric power, dramatically illustrated by the completion of the Itaipu dam in the South and the first stage of the Tucuruí project in the North.

The achievements in the areas of oil, alcohol, hydroelectrical power, and coal production are responsible for the drastic reduction in dependence on foreign energy sources, from 37.5% in 1979 to 22% in 1983. More importantly, these massive investments explain how the loans made to Brazil in the last ten years were spent.

Thus it is very difficult to accept—at least in the case of Brazil—that the debt accumulation is due either to mismanagement or to overconsumption. Of course, some mistakes may have been made. Perhaps Brazil overinvested. Some projects had a long return and turned out to be less profitable because of the rise in interest rates. But had it not been for these investments, Brazil would never have overcome its energy constraints and would have never been able to accomplish the structural adjustments responsible for substantial

trade surpluses now. It is a fact that the Brazilian economy was shaken by successive external shocks. At each time Brazil showed its willingness as well as its capacity to readjust. According to calculations, of Richard Mattione, Brazil experienced the biggest dollar shock among large debtor countries. Between 1979 and 1982, the cumulative effect of the deterioration of the terms of trade, high interest rates, and low export demands produced an impact on Brazil of the magnitude of $48 billion. The same calculations show that Brazil actively adjusted, "in the sense that the current account postion ($-23.6 billion) deteriorated by less than the amount of the unfavorable shocks." [1]

Brazil has actually made a very important adjustment effort. The results are significant as regards external accounts, the domestic front, and structural adjustments. But it is premature and overly optimistic to say that the debt problem is over or that it can now be solved without any further action. There are three main reasons for this:

(a) The debt service has become too heavy a burden. The Brazilian debt service for the next three years will be in the range of $24 billion, that is to say, almost the equivalent to this year's exceptional export revenues;

(b) The results of the adjustments have been significant, but no less significant have been their cost;

Per capita income declined 10.7% between 1981 and 1983;

Real wages continue to drop;

Despite a slight improvement in the last months, unemployment still runs high. Over four million people are estimated to be unemployed. Since there is no unemployment compensation, some 16 million workers and their families have no income at all;

The standard of living of the population, which has never been high, has fallen even lower. The consumption of beans, one of the staples in the Brazilian diet, has dropped from a yearly 25 kilos per capita in 1978 to 14 kilos in 1982, while per capita meat consumption dropped from 25 to 15 kilos.

(c) The most relevant variables of the debt problem lie beyond the debtor's control. All the sacrifices made by society to adjust the economy may have been in vain if these variables do not behave in a positive way, if the international environment does not become more favorable. Indeed, debtor countries are receiving contradictory signs: On one hand, they are urged to adopt austerity programs to increase their capacity to service the debt; on the other hand, the debt service becomes an intolerable burden owing to unprecedentedly high real interest rates. On one hand, debtor countries are encouraged to devalue their currencies in order to promote exports; but, on the other hand, the access of their products to the markets of industrialized countries is being hindered by a growing protectionist trend. It is estimated that about one third of Brazilian exports

[1] Richard P. Mattione, "Managing World Debt: Past Lessons and Future Prospects," Middlebury College Conference on the World Debt Crisis, September 20–22, 1984, Page 5.

to the United States is affected by some kind of restriction. Subsidies have become a sort of economic mortal sin. Dornbusch correctly points out that "from the point of view of U.S. income and employment it cannot make much difference whether debtor LDCs earn their debt service dollars by cutting down on imports from the United States, whether they earn them by promoting exports through a real depreciation or whether they promote particular exports through selective export subsidies. In each of the cases there will be a loss of U.S. jobs, be it in our manufacture exports sector that is affected by reduced foreign imports, or in our import competing industries that have to face up to increased competition from abroad." [2] On the one hand, debtor nations are urged to attract potential foreign investors; but, on the other hand, they are also urged to promote an across-the-board liberalization of imports, as if the main incentive for foreign investment had not been the protection of infant industries. It is a well-known fact that one of the major sources of protectionist pressure in Brazil is represented by the Brazilian subsidiaries of multinational corporations.

B. THE DEBT STRATEGY

The debt of non-oil developing countries, owing to its magnitude, number of countries involved, and the threat it posed to the banking community, is clearly different from previous emergencies in the financial system. At the end of 1982, the debt of non-oil LDCs amounted to $612 billion, their current account deficit reached $98 million, and 34 countries were in arrears. In 1983 rescheduling negotiations amounted to $90 billion. The response of the international community to the debt crisis took the form of collective action: central banks of creditor countries, the Bank for International Settlements, the IMF, and private banks provided debtor countries with the resources they needed to meet their external obligations and undertake adjustment programs. The so-called debt strategy was confirmed by the Williamsburg and London summits. It is now moving from a short-term to a medium-term approach. To what extent will the set of initiatives designed to deal with the debt problem provide the favorable environment debtor countries need to accomplish their adjustment?

The strategy consists of five elements: two major economic developments, namely adjustments on the part of debtors, and economic recovery in industrialized countries; and three different initiatives in support of the adjustment effort, on a case by case basis: the IMF programs, continued bank lending, and emergency interventions by central banks and governments. From the point of view of debtor countries, the present strategy suggests the following comments:

1. There is no arguing the debtor countries' need to undertake sound adjustments. Most countries were already in the process of adjusting their economies even before the eruption of the 1982

[2] Rudiger Dornbusch, "The International Debt Problem", Testimony before the Subcommittee on Economic Goals and Intergovernmental Policy, Joint Economic Committee, U.S. Congress, March 28, 1984.

crisis. The questions that might be raised, as already pointed out, concern the adequacy of the present model of adjustment, the social acceptance of a long-term austerity policy and the likelihood of a more favorable environment.

2. Recovery in industrial countries is essential to the adjustment process in debtor countries. The impressive growth rate in the United States this year strongly contributed to the resumption of growth in non-oil developing countries and explains the extraordinary increase in Brazilian exports to the United States in the first half of 1984. Recovery in industrial countries, however, has to be qualified by two considerations:

(a) First, it is surrounded by uncertainties and, it's mainly concentrated in the United States. According to Cline's projections, if the OECD growth rate stabilizes at 3 percent per year from 1984 to 1986, and LIBOR falls from 10 percent to 8 percent, domestic growth in debtor countries could rise from 2.5 percent in 1983 to 4.5 percent in 86.[3] But Cline's assumptions are considered too optimistic by other forecasters. Dornbusch and Fischer estimate that interest rates in real terms will remain in the range of 5 to 6 percent in the next years, in exceptionally high level by historic standards.[4] Data Resources Inc. draws two alternative scenarios for the U.S. economy in the next years. According to the more favorable one, in which some fiscal corrections are made, the U.S. economy in 1985 would grow by 2.1 percent, inflation would remain at 4.5 percent, and LIBOR around 12 percent.[5] Mention of these different simulations alone shows how uncertain the prospect of sustainable growth in industrial countries is. Even if the main variables behave favorably, and growth rate in OECD countries stabilizes at 3 percent and LIBOR remains at 10 percent, per capita GDP in most debtor countries will not regain its 1980 level before the end of the decade.

(b) Despite the better than expected results of the U.S. economy this year, recovery has not been followed by economic adjustment in industrial countries. As a result, real interest rates have remained excessively high and protectionist trends have intensified. If in 1984 high interest rates and protectionism have been partially offset by an exceptionally high growth rate in the U.S., they will impose severe constraints on the adjustment process of debtor countries as soon as U.S. growth rates slow down, as they are expected to do.

3. Just after the September 1982 crisis, the IMF was mobilized to support the efforts of creditor and debtor Governments in dealing with the debt problem. This mobilization implied an increase in IMF resources and a widening of its role. In 1983 a group of about 40 countries had already signed, or was negotiating, stand-by arrangements while some twenty others had concluded extended facilities with the Fund. New resources were provided to the IMF through an increase in quotas and the enlargement of the General Agreement to Borrow (GAB). Traditionally, the IMF stand-by

---

[3] William Cline, "International Financial Rescue: Viability and Modalities," UNDP/UNCTAD Project INT/81/046, September 1984, Pg. 15.

[4] Rudiger Dornbusch and Stanley Fischer, "The World Debt Program," UNDP/UNCTAD Project INT/81/046, September 1984. Pg. 41.

[5] Ibid. Pg. 41.

agreement was taken as the "seal of approval" for the pursuit of private lending. But in 1982, the fact that the private banks were no longer willing to meet the borrowing needs of debtor countries, led the IMF to impose the continued lending by private banks as a condition for its own participation in rescue packages. The IMF thus became the agent for the involuntary lending process, and is expected to keep this role as long as private financing remains on an involuntary basis.

In order for the IMF to be able to accomplish its task as the central coordinator of the debt strategy, two conditions have to be fulfilled:

(a) Increased participation of central banks and Governments of creditor countries in official lending to debtor countries to compensate for the reluctance of the banks to provide new money as well as for an eventual retreat of smaller banks from international lending.

(b) Revision of the IMF conditionality. The present IMF adjustment model has been conceived to deal with short-term imbalances: after an IMF-supported transition period, market forces should accomplish the adjustment. The present debt crisis, however, does not seem to be a short-term deviation. On the contrary, the debt service burden will remain for over a decade and voluntary lending is not likely to resume in the short run. As Simonsen points out, the present IMF conditionalities turned out to be recession biased, since they overlook wage-price rigidities. "A complicating factor is that some required adjustment policies, including exchange rate devaluations, indirect tax increase and subsidy cuts, imply a temporary acceleration of the inflation rates. Wage price stickiness combined with aggregate demand controls can lead, under such conditions, to dismal stagflation." [6] A final remark should address the paradoxical situation of many debtor countries, in which the successful performance of external accounts does not correspond to a thorough fulfillment of domestic targets. This raises the question concerning the consistency of the model as well as the real need of painful domestic measures to achieve the reequilibrium of external accounts. In other words, the experience of the two past years suggests the need for a revaluation of the present model, aimed at correcting its distortions so as to permit the reconciliation of adjustment with growth.

4. The adjustment programs agreed with the IMF have to be complemented by an appropriate flow of resources from the private banks to debtor countries. The system has worked quite well as far as the rescheduling of principal is concerned. But banks have been more reluctant and the procedures far more complex in reference to new money.

If it is true that creditor banks and debtor countries share a common interest in overcoming the debt crisis, it is also true that they have different approaches for the short run. As if suddenly aware of the risks of large exposure to developing countries, the banks, since 1982, seek to reduce this exposure as soon as possible, while avoiding any disruption to the international financial

---

[6] Mario Henrique Simonsen, "The Debt Crisis", May 1984, Pg. 10.

system. Debtor countries on their turn, while abstaining from steps that could threaten the stability of the banking system, are looking for different forms of alleviating the debt service burden—stretching out maturities, obtaining new money, reducing spreads, and eliminating fees—as a means to achieve appropriate growth levels.

One of the difficulties in accommodating these diverse approaches is the considerable differentiation among the banking community. As with debtor countries, there is a great diversity among creditor banks.[7] Large American banks have higher exposure, smaller reserves and tend to confer a high value to reporting large quarterly profits and to sustaining high rates of dividends distribution in the short run. For these reasons, they tend to resist any substantial change in rescheduling arrangements that could reduce profits in the short run.

The picture seems to be rather different as far as European and Japanese banks are concerned. Their exposure to Latin American debtors is lower, their reserves higher and they have been adopting specific loss provisions. Furthermore, they are not under strong pressure, either from shareholders or from bank regulations, to show high profits on a quarterly basis. As a result, some European banks tend to be critical of present rescue packages because of their high transactional costs; uneven distribution of the burden of supplying new financing among banks (due to differences in the currency composition of bank portfolios and in interest rates); and their short-term approach, which does not ensure the recovery of stability and confidence in the market.

Finally, small- and medium-size banks seem to be more openly critical of the way reschedulings have proceeded. Their relative exposure is considerably lower; they have been reluctant to participate in the involuntary lending; and they are more receptive to the idea of restructuring the debt service over longer periods of time at less than market rates.

The medium-term rescheduling of the Mexican debt, just concluded, had made some positive, although limited, steps toward the alleviation of the debt service burden. Nevertheless, it did not provide an answer to a basic question: will voluntary lending resume soon? If so, the debt crisis would have proved to be a liquidity crisis and the debt strategy only a transitional framework to support the adjustment of debtor countries until the moment when the market forces are able to promote reequilibrium. Unfortunately, this prospect does not seem likely. The banks seem inclined to shy away from international lending, at least to developing countries. In this case, a medium-term strategy to handle the debt problem will be required and an alternative to voluntary lending will have to be found.

5. Finally, the intervention of central banks and creditor governments in the setting up of rescue packages and of an operational framework to handle the debt crisis has avoided a disruption of the financing system that otherwise might have occurred. This intervention has an emergency nature, since it aims at providing

---

[7] For a comprehensive presentation of the differences among banks see Paulo Nogueira Batista, Jr., "International Debt Rescheduling since mid-1982: Rescue Operations and their Implications for Commercial Banks and Debtor Countries. UNDP/UNCTAD Project INT/81/046.

"bridge financing on a selective basis when apropriate." [8] And it assumes in the short run the coordinating role the IMF will take over later on, of actions taken by creditor Governments, central banks and the financial community.

The set of guidelines and initiatives which make up the so-called debt strategy has often been perceived as an asystematic approach to the debt problem. To a certain extent this is true, since "rescue packages" have only been set up "a posteriori", on a case-by-case basis, and as an "ad hoc" approach. but the different actions, if taken together, actually provide for the basic elements of a strategy: clear objectives, adequate instruments, and coordinated action. The main objective of such a strategy is to prevent the liquidity crisis of a main debtor from becoming a real threat to the stability of the financial system. The rescue packages have been set up for this purpose. Subsidiarily, the strategy aims at establishing an institutional framework to deal with the debt problem until the moment when the action of the market forces is able to restore equilibrium. The instruments of the strategy consist in the mobilization of the appropriate institutions and the setting up of special procedures—such as involuntary lending—to ensure the feasibility of the adjustment efforts of debtor countries. The actions taken by the different actors are coordinated at different levels: in "advisory committees", at summit meetings, and by multilateral institutions—basically the IMF.

What may be seen as an asystematic, "ad hoc", and emergency approach, is not necessarily a shortcoming, but a functional ingredient of the strategy. Cline remarks that "the more automatic debt rescheduling and financial rescue become, the greater is the 'moral hazard' of including unconscious policies by borrowing countries and, depending on the extent of automatic public suport, by private banks." [9]

As has been mentioned, the driving force to the setting up of this strategy was the potential impact of the debt crisis on the banking community. From this perspective, the debt problem may be reduced to a question between large banks and large borrowers. Batista points out that the claims of the nine largest United States banks on non-oil developing countries rose from $30 billion in December 1977 to $60.3 billion in June 1982. Exposure as a percentage of total capital is significantly higher for the nine largest banks (222%) than for the next fifteen largest (149%). Furthermore, "in recent years, about half of the nine major banks total claims on non-oil developing countries was accounted for by only three countries (Argentina, Brazil, and Mexico)." [10]

This explains what Cline calls the emergency of a "two track system". Countries whose debt is large enough to have an impact on the financial system, are entitled to the benefit of rescue packages and to receive bridge loans, which allow them to meet their obligations. For smaller debtors, bridge loans were generally not available and took the form of arrears.

---

[8] David C. Mulford, Assistant Secretary of the Treasury for International Affairs. Statement before the Subcommittee on Western Hemisphere Affairs, Committee on Foreign Affairs, House of Representatives, July 31, 1984.

[9] Cline, op. cit., pg. 21.

[10] Batista, op. cit. pg. 17.

C. MEDIUM-TERM PROSPECTS

The debt strategy is now moving from a short- to a medium-term approach. The London Summit declaration anticipates some of the actions that should be taken in order to cope with the debt problem in the years to come: emphasis on foreign direct investments, multi-year rescheduling, and an increased role by the World Bank.

Foreign direct investment has made an important contribution to the development of Third World countries. But in the last few years, drastic reduction in the growth rates in most debtor countries has led to a substantial decrease in the inflow of risk capital. In Brazil, foreign investment dropped from $1.5 billion in the late seventies to an estimated $800 million this year. As soon as the economy resumes growth, an increase in the inflow of equity capital is also to be expected. But it is an illusion to imagine that foreign investments could grow enough to compensate for the reduced private-bank lending or to represent a decisive contribution to debt servicing. Indeed, the whole volume of risk capital expected to flow into Brazil this year represents less than one month of interest payments alone. The main aspect of foreign investment is its qualitative contribution in terms of technology transfer, managerial skills, and labor force training.

Multi-year rescheduling represents undoubtedly an important step toward an improved handling of the debt crisis. Indeed, the main features of the recent Mexican package, such as the stretching out of maturities, reduction of spreads, and elimination of fees undoubtedly lead to an alleviation of the debt service burden and of the transactional costs involved in previous debt renegotiations. There is a clear, but limited improvement. The package is mute as to interest payments. Since the principal was not being paid, but rolled over, the new rescheduling model sets up more favorable conditions for paying that which was not being paid; but it does not deal with that which was being paid, either totally or partially—but always under the very unfavorable circumstances of high interest rates. Many relevant questions remain unanswered: in case of new increases in interest rates will there be any kind of compensation or safeguard for debtor countries? In case there is a gap between a debtor country's capacity and its interest obligations, will this be covered by voluntary or by official lending?

Better coordination between IMF and World Bank programs and, above all, increased participation of the World Bank in structural adjustments undoubtedly are also very positive steps. The IBRD has shown considerable flexibility in adjusting to the new environment through concentration on projects of short disbursement and by speeding up structural adjustment programs. An increased and desirable participation of the World Bank in the medium-term adjustment process of debtor countries seems to require the fulfillment of two conditions. The first is an increase in resources, proportional to expanded functions. The second is a thoughtful consideration of the problem of conditionality.

The World Bank is undertaking an extensive and fruitful reflection on its future role. Governments, banks, and the academic community are also engaged in studying the medium-term prospects of the debt. All tend to coincide in that the IBRD should have a major

participation in the structural adjustment, which is very positive. But some are also inclined to recommend the introduction of more stringent conditionalities in the Bank program.

Barend de Vries, a former World Bank advisor, for instance, in a recent paper, elaborates on a range of thought-provoking and interesting suggestions for the World Bank's future rule. In short, he proposes that the World Bank should take over in the medium term the coordinating role that IMF plays in the short term in regard to the financing and adjustment programs of debtor countries. Accordingly, private sources should integrate their operations with those of the official agencies and "support for structural adjustment or development projects should preferably be made parallel or in co-financing by the World Bank." [11] The financing coordination should be followed by adequate conditionalities, which in the case of the World Bank are "far more inclusive and diverse and often more penetrating" [12] than those of the IMF. The agenda for a medium-term strategy could include continued action on keeping the exchange rate abreast of inflation; liberalization of import regulations; assistance to export industries by further removing the biases against them in the incentive system; improving public sector management; removing government regulations in agriculture; assisting the rationalization of domestic credit markets. Barend de Vries's proposals, although more explicit and elaborate, coincide to a large extent with suggestions made in different circles for medium-term initiatives to handle the debt problem. These proposals elicit some comments:

(a) The short-term IMF conditionalities, if added to those designed by the World Bank for the medium term, more than being a mere set of conditions for balance of payments adjustment, constitute an actual model of development. There is no point in arguing whether this model is good or bad. Some of its policy guidelines are certainly positive and have already been or should be adopted by debtor countries. What is to be argued, however, is whether it is feasible to try to impose on debtor countries, through the powerful instrument of finance coordination, an almost ideal model, which even industrialized countries have not been able to follow. Indeed, fiscal deficits, protectionism, and subsidies are not a privilege of developing nations. If not even the most developed and powerful economies have been able to correct these distortions, there must be some sound reasons for this.

(b) The whole set of conditionalities may introduce real constraints for the management of the economy. First, there seems to be some inconsistency between the proposal of integrated and coordinated financing and the declared aim of resuming voluntary lending and returning to market forces. Secondly, more diverse and often more penetrating conditionalities would considerably reduce the flexibility in the management of domestic economics. What is the need for the adoption of such comprehensive conditionalities? The apparent answer seems to lie in the assumption that the debt crisis is due to mismanagement of the economy by debtor countries.

---

[11] Barend de Vries, "Future Capital Flows: Critical Improvements and the Role of Coordination", August 1984, pg. 18.

[12] Ibid. Pg. 26.

As a result, overcoming the crisis requires a monitoring of debtor countries' economies. It is difficult however, to accept the assumption of a simultaneous mismanagement of economic policies in about 40 countries in the years preceding the 1982 crisis. Furthermore, all attempts to explain the origins of the debt problem have to admit the unequivocal impact of external shocks.

One can also ask whether the set of conditionalities is designed to address the adjustment of the balance of payments only. The experience of the IMF programs in the last few years shows in many cases the paradoxical situation of an overperformance in external accounts despite a not so successful achievement of domestic targets. This raises the question whether some very painful domestic austerity policies are indeed required. Furthermore, over the medium term it can be argued that some more extensive conditionalities are the ingredients of a new economic model rather than a requirement for balance of payments equilibrium.

(c) As has already been pointed out, conditionalities address many of the main economic policies. In other words, policies for coping with major economic issues may turn into invariables as far as the domestic decision-making process is concerned. This takes place at this very moment when many Latin American countries are going through a democratization process, which gives rise to the expectation of greater society participation in government decisions. It is to expect then, that unless they are handled in a flexible way, conditionalities may lead to a collision course between economic adjustment and the democratization process.

D. CONCLUSION

Progress has certainly been made in dealing with the debt problem. But the results of the so-called debt strategy are perceived differently by creditors and debtors. From the point of view of creditors, the strategy is quite successful. A disruption of the financial system has been avoided, debt is being serviced in most cases, banks have managed to reduce their exposure, and debtor countries are pursuing sound adjustment programs.

From the point of view of debtor countries the evaluation of the strategy cannot be so positive. After almost three years of very low or even negative growth rates, drastic per-capita income reduction and high unemployment, they realize they shouldered alone the costs of adjustment. The prospects for the medium term, as far as they can be entertained today, do not seem to make room for a considerable change in this picture. Despite a modest resumption of growth in debtor countries this year, there are no clear indications that the recovery can be sustained and achieve adequate growth rates. The recovery in the industrialized countries is uncertain and not likely to be followed by the much needed economic adjustments. There are also indications of growing inconsistencies in the present strategy. While some countries have succeeded in improving their economic indicators, many others, despite their efforts, show clear signs that for them the debt burden is intolerable and its servicing unfeasible. Adjustment programs in most cases should be followed by additional financing. But the banking community is increasingly reluctant to provide new money, while creditor gov-

ernments reiterate that they cannot afford to increase official lending. Debtor countries are committed to pursue their adjustment efforts, but it has become clear that they cannot bear the present social costs in the coming years.

The present strategy has been able to avoid the worst. But it has not been able to pave the way for a long-lasting solution. Its ad hoc and emergency nature prevents it from adequately coping with much more complex economic problems underlying the debt crisis. Nor can it permit a long-lasting conciliation of the legitimate interests and actions of all actors in the play—creditor banks and Governments, multilateral institutions and debtor nations. It is time for a joint reflection on the experience of dealing with the debt crisis till now. It is also time to join together in a discussion of medium-term prospects in a spirit of mutual responsibility and willingness to share the burden, in search of a compromise solution for the benefit of all. That is the basic message of the Cartegena movement and the purpose of the dialogue it has suggested.

Mr. REIFMAN. Let's hear from Christine Bindert, senior vice president of Lehman Brothers, formerly of the IMF, tell us about the problems as seen from the point of view of a small Latin American country.

THE DEBT PROBLEM OF THE SMALLER COUNTRIES—BY CHRISTINE BINDERT, SHEARSON-LEHMAN BROS., AMERICAN EXPRESS

Ms. BINDERT. Well, I'm delighted that Sergio pointed out the asymmetry between big debtors and big creditor countries because the asymmetry is also very striking between big and small debtors. I would like to preface my remarks by saying that on purpose I will try to be as provocative as I can. This is made easier by the fact that I'm not Latin American, despite my accent. I'm actually from Belgium. I'm also not a commercial banker as I'm working for Lehman Brothers, an investment bank as advisor to a number of LDCs governments. I sit on the side of the debtor and advise the government on a wide range of economic and financial issues in particular on debt restructurings. I have been involved in debt rescheduling much longer than I would like to remember since my first debt rescheduling experience goes back to the mid-70s when I was involved in Africa in both the rescheduling of Gabon and Zaire's debts.

To make it very clear, my presentation will be from the point of view of a debtor country and not from the point of view of the issues that a creditor country or a banker has to deal with. Since Larry Brainard and I usually sit on opposite sides of the table and as most of my remarks will draw on the experience of Costa Rica. Larry will no doubt correct me and give you this afternoon his own point of view of the same situation.

Now just to warn you on how biased I am, I would like to quote President Belaunde of Peru as reported in the Wall Street Journal of October 16: "Something must be done about the debt, [. . .]. It is like we are on a sinking ship running around patching holes one after the other. We go from one crisis to another. It is not only very annoying, it is also very costly."

I'd like to briefly—and, I'm not going to ask for a waiver as Sergio did because small countries don't get waivers! They're just told that they can't get what they're asking for, so I'm not even going to attempt to ask for it, but I'm going to just try to be as brief as I can. Nevertheless I would like to mention the experience of Costa Rica over the last two or three years because I think it has some relevance for other small debtor countries.

By small, I do not refer to the size of the countries. What I mean is basically countries which do not have much leverage, as the size of their debt is too small to affect the international financial system and in most cases, although I guess it could be debatable as far as Costa Rica is concerned, these countries are not very significant in the political arena.

After briefly describing the experience of Costa Rica, I would like to address some of the current issues that these countries are faced with particularly in light of the well-publicized multi-year reschedulings of both Mexico and Venezuela. And then, since I have decided to be particularly provocative this morning, I will even dare to suggest a modest agenda for the future which I hope everybody will find debatable.

When the so-called Troika,[1] got first involved in Costa Rica, we were actually not asked by their government to advise them on how to reschedule the external debt because nobody knew there was a debt problem.

Actually, we were initially consulted as to the possibility of rolling over Costa Rica's short-term commercial bank debt.

When we arrived in San Jose, the capital of Costa Rica, we realized that the authorities had basically no idea how much debt they had accumulated, how much of that debt was short-term versus long-term, and basically the authorities didn't have a breakdown of to whom the debt was owed.

That may sound incredible, but it is not and it's not unusual for a sovereign debtor not to have a very good overview of its total external debt. Since then, there have been well-publicized examples in the press of similar data problems in other countries such as Argentina and Venezuela, just to name two.

In order to help the government in rolling over Costa Rica's short-term debt, we felt that it was indispensable to have a better handle on the structure of the debt as well as on the other side of the equation namely how much foreign exchange the Central Bank had available in order to service ongoing debt service obligations.

We went—it sounded very logical—we went to the Central Bank and the Ministry of Finance to try to find out exactly what was the situation and after a few long meetings it became fairly clear that these data were not readily available. It took us a couple of weeks to crank the numbers. We found out then that the country was basically bankrupt. There was no foreign exchange left in the Central Bank. By the time we were hired things had already deteriorated that no money was left to service any debt.

Mr. REIFMAN. Was there money left to pay you?

---

[1] Lazard Freres (Paris, New York), Lehman Brothers Kuhn Loeb (London, New York) and S. G. Haeburg are three investment banks which since 1975 have jointly advised some 18 developing countries on a wide range of economic and financial issues including debt strategies.

Ms. BINDERT. Barely. That's usually a question that bankers ask. I didn't expect that from you.

Mr. REIFMAN. I'm sorry. I'm trying to live like a banker. [Laughter.]

Ms. BINDERT. The situation was further complicated because, as in most countries, very few high officials and policymakers had ever handled a crisis of such a magnitude, so everybody was basically running around wondering what they should do.

In addition, commercial bankers were lining up in front of the Ministry and the Central Bank and were sending telexes and telephoning pressuring the authorities to pay them back. And the IMF team and the World Bank were also calling on the same ministers and the same governor of the Central Bank to discuss the measures necessary to redress the situation, and these measures, as advocated by the Fund and by the Bank were not always completely consistent.

Finally, the same ministers and the governor were also under pressure from their own cabinet and from their own government to try to explain what was going on. In most small countries the staff in Ministries and the Central Bank to whom the top policymakers can delegate is very limited, so basically all types of decisions from the most menial ones to the most important ones have to be taken at the highest level.

In the case of Costa Rica, the situation was made even more complicated by the fact that we were dealing with a government which was in the last year of its administration and for obvious reasons was very reluctant to introduce drastic austerity measures and be seen as yielding to foreign creditors and the IMF.

So between August 1981—and this is you recall pre-Mexico crisis—and May 1982 when a new government came into place in Costa Rica, the domestic economic situation deteriorated markedly. There was no IMF agreement and no agreement was reached with external creditors.

Debt service obligations to official and commercial creditors were virtually suspended resulting in a massive accumulation of external arrears.

When the new government was sworn in, it immediately created the post of "Special Adviser to the President on External Debt Matters" with rank of Minister, which I think was quite an unprecedented nomination. I don't know of any other country where there's actually a minister whose only function is to renegotiate external debt. A drastic austerity program was introduced and negotiations with the International Monetary Fund were resumed and a strategy was devised to negotiate with commercial bankers.

By May 1982, the accumulation of external arrears—both principal and interest—had become massive. As I mentioned earlier, since the third quarter of 1981, virtually all debt service payments had been suspended.

The government decided that some gesture should be made toward the creditors in order to try to improve the negotiating atmosphere and to try to move toward a better contractual relationship with creditors. As result, the Costa Rican authorities introduced an interim payment plan by which the government allocated a certain percentage of export receipts and capital inflows to debt

service. This is to my mind very important and I will come back to that when I am talking about the future because as far as I know there's no precedent for a country actually linking its debt service payments to a certain percentage of export receipts and capital flows.

We are still talking about pre-Mexico crisis. On the eve of the Mexican settlement, in November 1982, Costa Rica was fairly well advanced in its negotiations with commercial banks and the main terms and conditions had actually been discussed and were virtually agreed upon.

But when Mexico's terms and conditions were made public in December 1982, the bankers turned around and because of their concern about setting a precedent in the case of Costa Rica, argued that since Mexico was a lesser risk than Costa Rica the so-called "rescheduling market"—an absurd term given the circumstances—dictated higher spreads and fees for Costa Rica.

To give you one example, in the case of the terms that had been agreed to prior to the Mexican debt rescheduling we had successfully avoided any reference to Prime as a reference rate to base the pricing of the restructuring. As soon as the Mexicans, for reasons which so far I find hard to understand, agreed to Prime, immediately we got stuck with it as well.

Now that brings me I guess to the issue of what can small countries such as Costa Rica, Peru, and Chile, just to name a few, expect from the current third or fourth phase, whatever you want to call it, of rescheduling and, in particular, in light of the recently concluded Mexican multiyear rescheduling which has been hailed as a great step forward. To my mind, the progress is just an apparent one. The rescheduling exercise for big debtors like Mexico cannot cover up the fragility of other arrangements which have been negotiated so far.

Until now, as I think Sergio pointed out very well, the whole burden of the adjustment has been borne by the debtors. While fiscal deficits in the United States and other industrialized countries are substantially larger today than they were in the 1970s, debtors have been compelled to adopt draconian belt-tightening adjustment programs.

The IMF, which in the cases of Mexico, Brazil and a couple other countries such as Yugoslavia, played a crucial role in "arm-twisting" commercial banks and "forcing" them to lend billions of dollars in additional money has exerted little efforts in assisting smaller debtors in mobilizing additional external financing.

The result is, of course, that the adjustment in those countries has usually been more stringent and the social fabric of these countries has been severely tested, while the private sector has been adversely affected by a lack of working capital as a result of massive devaluations and tight credit policy.

Now it's clear, as I think nobody will object, that growth is the only way out. But how are we going to stimulate growth? The public sector does not have the means to invest on any meaningful scale, unless, of course, the objective of keeping a lid on inflation is being relaxed, but that's hardly an option.

The private sector, in addition to being decapitalized, is demoralized and in many countries is taking a wait and see attitude vis-a-

vis its own government. Investments are being postponed, and at a first sign of overvaluation capital flight resumes. Obviously, this is not particular to small countries.

In many of debtor countries, as a result of the drastic deflationary programs, the private sector is running at 40 or 60 percent of capacity, as was also pointed out by Bill Cline. Demand—full inflation has in many cases given way to cost-push inflation.

The key to future growth is structural adjustment. But the problem is how do we get from here to there? The IMF is dealing with here and the World Bank is, I think, trying to deal with there, but nobody has really stopped to consider how we go from one to the other.

In a number of cases of countries that I'm more familiar with, smaller debtors, the World Bank has sent very large missions to look into structural adjustment problems, but partly because the country has only a handful of policymakers who can deal with these issues and they are already engaged in marathon sessions with the IMF and the banks, structural adjustment is not being given as much priority as it should be. But how much can an economic team deal with?

To understand the issues is not very easy, but to follow up and monitor the implementation of the structural adjustment programs can be an even more trying task, especially when the IBRD shopping list of conditions is quite extensive. And to my mind, the World Bank has been too ambitious in a number of cases in its undertaking at the cost of losing a great deal of its influence.

The next point I'd like to stress is that I think there's been a tremendous misunderstanding about the role of suppliers and multinational companies in the debt crisis. Much more attention should be given to repaying suppliers and keeping current vis-a-vis multinational companies which in most cases, and even in small countries, are in for the long run, much in contrast to most commercial banks except maybe the very largest ones. Hence, it seems to me that some rearranging of priorities in the allocation of foreign exchange should be seriously considered with short-term trade debt excluded from rescheduling arrangements altogether.

Now to get back to the Mexican and Venezuelan multi-year reschedulings, as I think Sergio already pointed out, these reschedulings have not really tackled the real issue. They have addressed the issue of principal but nobody ever expects these countries to repay principal. But as far as interest is concerned, nothing has been resolved. In most of the countries that I am referring to the real issue is how are these countries going to be able to service interest.

It's quite clear that it's going to become increasingly difficult to argue that new money is needed, especially when little or no light is there at the end of the tunnel.

In the case of Mexico, I think it's also very important to keep in mind that the underlying assumption of the rescheduling was that within six to twelve months Mexico could go back to the market. I understand that Mexico has already hinted that for 1985 it may need as much as $1 billion from the banks, although they have also said that if need be they could use their reserves.

Going back to the market shortly may be possible for Mexico. It's hardly an option for Costa Rica and Peru and many other countries in the hemisphere.

The real danger of the present situation it seems to me is that the "resolution" of the Mexican crisis will translate into a loss of the sense of urgency about the debt crisis which—at least to some extent—prevailed in Washington up to now.

President Reagan declared at the IMF/IBRD annual meeting that the debt crisis was over, but if the debt crisis is over, why aren't countries like Bolivia and Peru able to keep current on their interest payments and why aren't banks willing to resume voluntary lending? It seems to me that the debt crisis is far from over and that actually we haven't even tackled the real issue, which is development and trade, and how are we going to get through this decade and into the next one without political and social instabilities in Latin America.

The challenge ahead is much more than just dealing with individual countries. The challenge ahead is to preserve our multilateral system intact and to give small and bigger debtors alike an opportunity to get out of the hole. The debt crisis has politicized international lending to a great degree and there's a very dangerous temptation to further bilateralize and politicize financial and economic issues.

Costa Rica, for example, has over the last two years benefited to a large extent from U.S. assistance, but obviously the inflow of the dollar has not been without strings.

Recommendations: To conclude let me briefly outline a modest agenda for the future. It's obvious to me that on the basis of what we have learned so far there has been overlendingin the '70s and that nobody is advocating that we should go back to the pattern of commercial bank lending that prevailedin the '70s. This is of course particularly true for Latin America but it's also true for some other countries like the Philippines in Asia and for most African countries.

The first proposal I would like to put on the table is for the poorest countries, most of which are actually in Africa and not in Latin America.

Serious consideration should be given to the cancellation by industrial countries of official debts. It's totally unrealistic to go year after year through the Paris Club exercises and pretend that some day these debts will be paid. Moreover, the amounts in most cases from the point of view of creditors is not that significant.

My second proposal would be that in a number of reschedulings there has been a tendency to lump together short-term financing with medium and long-term balance of payments loans which I think is a mistake. Except in exceptional cases, trade credits would be excluded from rescheduling arrangements. Trade credits are vital to the resumption of growth in world trade and future recovery. Food and oil bills have to be paid on time to avoid disruptions in supplies which could cause serious social and political instability.

If necessary for smaller countries, banks should be given assurances and even guarantees if it is necessary to keep trade credit flows from decreasing. Export credit agencies would also do well to

revise the present policy of halting the extension of new credits to countries which have rescheduled their debts.

My third proposal—and I think Sergio has already mentioned this—is that the World Bank should play a much more crucial role in reviewing countries' investment strategy and advising on the structural reforms which are necessary for increasing production, exporting, employment in the medium and long run. But the proposed reform should be progressive and pragmatic and geared toward addressing the most fundamental issues first. Trying to solve it all just won't work. Either the program will be rejected at the outset as too radical and politically unfeasible or it will be agreed upon but not fully carried out because it cannot be implemented in full.

Now such a medium-term strategy I think will probably require for some countries, especially the smaller ones, rethinking the current rescheduling packages. It's in everybody's interest to give the debtors some breathing space. Liquidity and financing are needed if structural changes are to be implemented and investments in quick yielding projects stepped up.

A number of proposals to alleviate the debt burden of LDCs have been made over the last 18 months but none have been translated into a blueprint for action for obvious reasons. Industrial governments have so far been unwilling to foot even part of the bill and commercial banks have not been very eager to cut into their income.

For most debtors, net new money from commerical banks is an unlikely prospect. Hence, I would suggest for countries which are in severe liquidity crisis linking the debt service payment to a certain percentage of export receipts and non-tied capital inflows may be an option worth considering. After all, in the '70s, a 25–30 percent debt-service ratio was considered very high. Today, most Latin nations' debt payments amount to about 50 percent of export receipts.

A flexible debt service payments formula could be introduced to reduce the debt service burden but could also be coupled with another 20 to 25 percent of export receipts being allocated to a trust fund which function would be to reinvest those proceeds into investments in the country to, in the medium term, generate growth which after all is the only way that debt can one day be serviced on time.

The allocation of the funds to the various projects could be monitored by the World Bank which has a unique expertise in medium-term structural adjustment programs and investment strategies.

My next recommendation would be to have the debtors follow suit on the Cartagena declaration, and as a first step, to enhance the flow of information among themselves. Surely, the Minister of Finance of Brazil talks to his counterpart in Mexico and Venezuela, but surprisingly, the small countries have very little knowledge of what's actually happening in the big countries and they don't always understand the key assumptions that have been taken by some of the other countries in their negotiations with commercial banks.

Finally, as the private bank lending euphoria of the '70s is neither desirable nor likely, industrial countries should renew their

commitment to official assistance for a substantial increase in the resources of the multilateral institutions such as the IMF and the World Bank. It is clear that the financing role of these institutions is lagging both behind the increase in international trade but even more behind the increase in international capital movements.

I think the restrictive position of the U.S. Administration and some other industrial countries has also precluded the SDR—the IMF international reserve asset from playing a significant role. In the end, I think it's the U.S. who has to reaffirm its leadership by reversing its current position and supporting a significant increase in the resources of the IMF and the World Bank, allowing a major new allocation of SDRs, promoting consistent, coherent and coordinated domestic and international economic policies because without the U.S. taking a leadership role nothing will be done and we will continue to muddle through.

Mr. REIFMAN. Thank you very much, Christine. These were two good talks. The floor is open for comment.

Mr. FRANKEL. I have sympathy with most of the comments. They contain some good ideas.

The debtor countries are now running big trade surpluses to pay some of the interest. We know that's not going to go on forever. In the best of scenarios, confidence will be restored and eventually the countries will go back to running at least a balanced trade or trade deficits that flow with resources coming into the country.

What are we talking about? Are we talking about it happening in the 1990s or are we talking about it happening next year? There's a tremendous difference there and different people's scenarios I think cover that whole range. But I think that's something to start thinking about if we are past the crisis stage—what is the optimal path back—and perhaps our banks and countries and other actors have very different scenarios in mind.

Mr. REIFMAN. Thank you.

Bill, you have the answer to when we're going to turn the balance of payments around in your forecast.

Mr. CLINE. It's even longer than you think. In fact, the balance of payments projections in Mexico and Brazil—you mentioned the National Bank of Development of Brazil has just made projections which have continuously rising trade surpluses. But the basic answer is it's not going to be soon, nor necessarily should it be, in line with the analysis of the export-led growth and this not being a real depressant on growth.

But both of the last speakers have said that the Mexico package didn't address interest rates. I'd like to say something about that.

The Mexico package reduced the effective spread above LIBOR for Mexico in the rescheduling packages from two and seven-eighths percentage points to one and an eighth. That's a very large cut. That's taking account of both the reduction in spread and the shift from prime to LIBOR, which is worth about three-quarters of a point.

The original terms on which Mexico was borrowing was 0.9 percentage points above LIBOR. So it's almost back to the original level.

So to go further than what was done in the Mexico package has a little more mileage by forcing the banks to accept a zero spread,

but that's still not very much. If you force the banks to accept a negative spread and make concessional interest rate agreements, then you are damaging the country's credit standing in the indefinite future. It doesn't seem to me that this is desirable for the country itself.

So the real substance to the statement that you're not dealing with the interest problem can only mean, if it does mean something, that the monetary and fiscal authorities in the industrial countries have not taken sufficient steps to reduce the underlying base interest rate. That's a quite different question.

It's related in fact to this other question that there's been adjustment in the South but no adjustment in the North. Well, the governments in the North are not parties to the negotiation in the first instance. The parties are the banks in the North and the governments in the South. Not to say that in addressing the problem the party in the South has taken its adjustment but that somehow the party in the North hasn't adjusted is a bit misleading because these are not governments who are at the other end of this transaction.

As for the banks I might say, it's often said that they haven't done any adjustment at all. Well, that's not quite true. By expanding their exposure in a risky situation they have in fact been taking on some of the adjustment burden and they have been paying for it in reduced value of their shares on the stock market.

But I just want to clarify a little bit the substance of what it really means that interest has not been addressed because I think the Mexico change in interest rates is quite significant.

Mr. REIFMAN. Ted Truman of the Federal Reserve.

Mr. TRUMAN. I would like to comment on maybe picking up this line and some things that were said earlier and maybe just one point on the large country-small country problem.

It seems to me—and I gather it's something one can blame on the development literature if I can put it that way—that there is a lot of confusion on the question of when there is a net transfer going on and I guess the development economists have gotten us into the habit of saying that there's a net transfer going on when the country is running a trade surplus, and as far as I'm concerned and as far as most elementary accounting is concerned, there's net transfer going on when their country is running a current account surplus.

One of the reasons why committees end up focusing on interest is because they don't count that as part of paying for the capital that countries have already received, even if it's a question of capital that has been rechanneled out of the country. I think it's a disservice to the debate to draw such a distinction in this context essentially between what's going on with the trade account and what's going on with the current account.

However, a question arises it seems to me as to whether in fact in the current circumstances or over the balance of the decade—Jeff Frankel's question—what countries should be doing. It's not, it seems to me, straightforward that the right proposition for developing countries in the current environment is that they should be running large current account deficits or even deficits at all, at least in some of the individual cases.

I think there are two points that could be made. One is a small point. I think most studies show that the net capital inflow associated with current composition of investment plays a relatively small role in terms of the growth potential of the economy as a whole. That goes to the whole question of internal adjustment.

On the other hand—I think this is the more important and interesting question in this connection, and it's one which takes the external environment as given—is the question whether the optimal policy from the standpoint of the debtor at this point should be to continue to accumulate external debt by running a current account deficit.

If you're in an environment because of lack of adjustment in the North, as Bill Cline just put it—lack of adjustment in the North and high real interest rates—then it's not clear that from a country's standpoint the best investment at a point like this isn't to repay external debt. And it seems to me that gets away from the moral issue, if I may put it that way, of who should be transferring resources, into the economic issue of what is the optimal position from the borrowing country's point of view.

The second point, as long as I have the floor, that I'd like to make is on Christine [Bindert's] talk, on the large country-small country phenomenon, and without trying to take that issue on head-on because I guess I'd be inclined to admit that there certainly has to be some element of that involved, the issue becomes one of where you draw the line.

Christine explicitly lumped Chile and Peru in with Costa Rica and then subsequently Bolivia in her concluding remarks, and I think from one standpoint clearly Chile and Peru are smaller than Argentina and Brazil and Mexico. But the issue that comes up, especially in the context of, let me call them, radical solutions for small debtors is the one of determining who is eligible and ineligible because the debtors or borrowing countries are arrayed along a spectrum. Especially to the extent that you are handing out what someone further up the line clearly is going to regard as a "goody", you run into moral hazard questions and issues that Bill [Cline] has talked about that have feedback effects in terms of the functioning of the system as a whole. It seems to me in the view of an economist only, to talk about the difficult political problems of a country associated with this process, it's going to be more difficult if one sees one's maybe slightly smaller neighbor—Chile, for example, versus Argentina—getting some special arrangement, if you want to put it that way, because of the smallness of their debt and the non-threat to the financial system.

It would seem to me the political problems in terms of Argentina or Brazil or even Mexico of that kind of solution would be severe—or relatively more complicated, let's put it that way—in terms of the viability of the country's operation.

Mr. REIFMAN. Larry, did you want to comment?

Mr. SJAASTAD. Yes, very briefly. This is a very emotional meeting; we've been running through all the emotions from optimism to some pessimism and now we're taking a sympathetic approach. [Laughter.]

I want to take what's known in Washington as a hard-nosed approach.

One could actually ask of a country, how did it get into that position or, put another way, how could these countries borrow so much money and not be able to pay? In fact, the bottom line is that an awful lot of these funds were borrowed for purposes of financing fiscal deficits. They weren't borrowed for investment, etc.

I know a bit about the Panamanian case. They've got one of the biggest deficits in the world, probably the biggest. If you add it all up, public sector debt amounts to more than $4 billion—100 percent of GNP—and they've just squandered it. There's no doubt about that. In fact, there's a book about that.

But Panama has a advantage because it has a canal which has been recycled and Costa Rica does not. Maybe Costa Rica should get a canal.

Ms. BINDERT. And get the banks to finance it.

Mr. SJAASTAD. In the other countries, of course, it was recycled in a different way. I made some recent calculations in the case of Argentina, Mexico, Brazil, and Venezuela, whose combined external debt totals $275 billion, that the private sector has foreign assets of $150 billion. The net debt is $125 billion and that's very easily serviced by a group of countries whose combined GDP is over $500 billion. There isn't any debt service problem when you look at it that way.

Why they have a debt service problem is that their own internal policies are so bad that the constituents of these governments found it worthwhile and attractive to sell their governments short, sell their country short, and our bankers took the long position. Now who was the fool?

Mr. REIFMAN. Thank you, Larry.

Kris Hallberg.

Ms. HALLBERG. I've got a question for both speakers and that is you both referred to a need for a structural adjustment. Everyone always does. But what I'd like to know is could you be more specific about what kinds of structural adjustment is needed and I'm particularly interested in the contrast between the small country case and the large country case. And following that, what do you see the IMF and World Bank role being in the future in promoting that kind of structural adjustment and does that role involve an expansion of the current role of the IMF in these countries?

Mr. REIFMAN. We'll get to many of these questions later.

Elinor Constable.

Ms. CONSTABLE. Well, the last two speakers succeeded in being so mewhat provocative because I am prompted to say something and I was going to try and listen I will go back to that mode rather quickly because I'm merely here to learn.

Jim Conrow [U.S. Treasury] will be with us and will talk to you about the view from the Government so I don't really want to get into that, except to say tht those of us who are looking at the debt problem are thinking and have been thinking for sometime about how our policy can and should evolve. I'd like to emphasize evolve because from where I sit I don't think change is the right word. I think the policy so far has been as right as policies get, and I don't happen to think that the U.S. Government has been terribly successful on the economic side for a hell of a long time, so I may have rather realistic standards in terms of policies.

Now if I may be provocative. It really doesn't help to think of too much adjustment by the debtors, standards of living that are dropping too fast or too far, insufficient resource transfers or resource transfers going in the opposite direction, or rather the wrong direction, therefore let's get more official resources and throw them at the problem.

I think it's fine to talk about more money for the World Bank. The position of the State Department on that issue is very clear and has appeared in the press more often than it ought to. We are also known to support additional resources for the IMF.

But the interesting policy questions it seems to me, don't lie in that area. In looking at the debt policy and how we get, as Christine Bindert said, from here to there, which is precisely what we want to do, the interesting questions lie elsewhere.

What should we be doing or supporting in the area of both official and private rescheduling, restructuring? What should the role of government be in this process? Should we be more or less active?

A couple of comments have been made about official reschedulings. I was wondering if we would ever get to that element of the problem. It may interest you to know that we already try as best we can to reduce rescheduled short-term exposure, precisely for the reasons that have been outlined.

But I just want to make a plea as we move through this discussion for more focus on these kinds of questions. We all have the message that we need more money. Okay. We can argue about how much more we need. What is really more interesting is how you apply those resources on the official side and what sort of policy framework you ought to be looking at as the private transactions play out in the next several years.

I'll get off my soapbox and I won't make that speech again.

Mr. REIFMAN. Elinor, that's a good question. I think Larry Sjaastad would say the question is whether governments provide more resources or whether we let the commercial banks and the debtor countries work it out among themselves without any interference by governments and without additional official lending.

Sergio Amaral.

RECENT MEXICAN RESCHEDULING AGREEMENT

Mr. AMARAL. So many remarks have been made that I don't know where to start. But let me comment on some of them. In reference to Cline's remarks, I believe, indeed, that the Mexican package represents an improvement. And I expect Brazil to achieve similar results. Nevertheless, what I am questioning here is whether this kind of rescheduling is, indeed, the final solution. I see it as a first step; but other important steps must still be taken.

There was, indeed, a reduction in spreads but I am not sure it was so considerable. If you take into consideration the negotiations with Mexico early this year, the spread, if I am not wrong, was 1.5, while the average spread in this new package is 1⅛. There was indeed a reduction, but not a big one.

The problem, however, goes beyond the reduction in spreads because it has mainly to do with interest payments. Where will the resources to cover interest payments come from? Will Mexico be

able—in the medium term—to pay its obligations from its own resources? Are the funds going to come partially from new lending, or will there be an increase in official lending? What I mean is that the Mexican package is silent in regard to this point—which is probably the most important one since Mexico, Brazil, and other big debtors, for the time being, are not paying the principal, but interest.

As for adjustments, my point was, basically, an asymmetry of efforts between creditor and debtor countries. I believe that the banks have adapted and, again, the Mexican package is a good example of that. However, when it comes to the adjustments in industrialized economies, they offer no comparison to the efforts that have been made by the debtor countries.

As to the transfer of resources, I think this is a very good point and I think, also, that it is very difficult to define what the net transfer is. I am sure that most debtor countries are quite aware that the solution to the problem is not a return to the overlending and overborrowing of the 1970s. The idea is not to go back to that situation but, rather, to accommodate a reduction in borrowing with the financing needs that can ensure minimum growth levels.

As to the difference of treatment between big and small debtors, which Christine pointed out very accurately, I wonder whether this difference comes only from the big debtor's political leverage. The difference may also come from the fact that the large debtors pose a much bigger threat to the financial community—perhaps, these are the reasons for their political leverage.

Policy options: What are the best policies to be taken? This question is indeed difficult to answer. Two aspects have to be taken into consideration. First, is the diversity of situations among debtor nations. Second, the different approaches between creditor governments and banks on the one side, and debtor countries, on the other. Creditors are mainly concerned about he stability of the financial system. Debtors, although also concerned with the financial system, are mainly worried about the feasibility and social acceptability of the present adjustment model in the medium term. There are thus different situations and approaches. The right policy can only be defined taking into consideration all these aspects and with the participation of all parties concerned.

This leads to other questions which have been raised concerning the demonstration effect of eventual concessions made to smaller debtors. This issue could possibly be handled in an adequate way, once more, in the framework of a joint discussion of the debt issue, in a spirit of co-responsibility and more equitable sharing of the burden.

Structural adjustments have also been mentioned. I did not have the time to deal with this question in more detail and to present a broader picture of the significant results achieved by Brazil in this field. The World Bank has been playing an important role in this context. We are very pleased to recognize the support we have been receiving from it. We think it should increase its participation in the structural adjustment process. For that purpose, as I mentioned before, the World Bank would require additional resources and a flexible approach to the conditionality issue.

Mr. REIFMAN. Thank you, Sergio.

Ms. BINDERT. Sergio basically covered it all and we are all hungry so I will just limit myself to a couple brief remarks.

I think the problem of the credit standing of a country which Bill pointed out is a very important one. The issue I referred to when I was talking about the Mexican agreement was the fact that in most cases small and medium sized Latin American countries do not have the resources available to even keep interest current. So the issue is not just the spread but the issue is where is the money going to come from to be able to service interest?

I think the case of Peru is a telling one because I don't think the issue is what is going to happen two or three years down the road. The issue is what are we going to do about situations like the one in Peru and Bolivia, to mention another one. I'm not going to talk about the one Larry Brainard and I worry about every day.

The issue of where to draw the line, as the Federal Reserve economist pointed out, is a very relevant one. The reason why nothing has been done so far is the fear of a spillover effect on other debtor countries which do not receive special treatment. This is quite understandable.

It would be very hard to manage, giving concessions to one country and not having the other ones asking for the same concession, although it would be interesting I think to see how the bankers react to the so-called precedents of Mexico and Venezuela when they sit at the table with the other countries and how much of that is really going to be a precedent for the smaller countries, as limited as the precedent is, and maybe Larry Brainard can shed some light on that in the afternoon.

As far as the issue that Elinor raised, sure, that's the issue. Of course, I don't have an answer. I mean, that's a very important question, but one way I think would be to maybe put more emphasis on coordination and pragmatism. I think that the coordination by the Fund and the Bank has to be much better than it has been in the past, both in terms of the policies and the speed of the adjustment. Very often there's a very big lag between the two program (IMF stand by and World Bank SAL, structural adjustment loans), especially in the first year. Although over time the World bank will catch up with some of the programs since most of these countries will go through a number of standby arrangements in the medium term.

Structural adjustment—what does it mean? It means basically what the IMF and the World bank have been doing, having the macro economic framework set right, having the share of the public sector diminish, giving the right incentives to to the private sector, reform the banking system if it's not very efficient, changing some of the institutional framework. I don't have any quarrel with the type of measures that have been advocated by both the IMF and the IBRD.

The issue it seems to me is the speed at which these measures can be implemented. There is a need for a much more precise but much more pragmatic calendar so that you don't run into trouble after six months or one year because of political pressures with measures that have such a political content that they are totally unacceptable.

Another area, especially for smaller countries, where the World Bank and the IMF together could be very useful is to provide more technical assistance. They are already moving in that direction. A lot of changes, especially in respect to debt management and institutional framework, such as reforms of the budget, the administration of the tax system, are difficult for countries to envisage. The changes in some cases have to be very drastic. I think it's certainly an area where the World Bank and the IMF should enhance cooperation.

Mr. REIFMAN. Thank you.

I propose that we go to lunch and then we will pick up in the afternoon with Larry Sjaastad and then go on with the rest of the program.

[Whereupon, at 12:55 p.m., the conference recessed, to reconvene at 1:45 p.m., the same day.]

AFTERNOON SESSION

Mr. REIFMAN. Larry Sjaastad, do you want to tell us where Latin America went wrong and Korea went right.

CONTRASTING EXPERIENCE OF LATIN AMERICA AND KOREA—BY LARRY SJAASTAD, UNIVERSITY OF CHICAGO

Mr. SJAASTAD. I had the feeling in the morning session that we weren't making quite enough distinctions among the countries because there are enormous differences as we go from country to country. There are some similarities, but again, they can be drawn only in a very broad way.

One way of characterizing the debt problem is that the debt was incurred when the dollar was cheap (which means when goods were expensive); indeed much of the debt was incurred in '79 and '80 when the dollar was at its very bottom and the debt service is coming when the dollar is very expensive (meaning that goods are cheap). The result is that countries are having a very tough problem in coming up with enough goods. They borrowed dollars and bought expensive goods and now they are having to sell cheap goods to service the debt.

This is one of the main things I try to establish in my paper. There, I do it in terms of real interest rates. And if you have a copy of the paper, I would suggest you turn to page 8 and the table. The last column gives the real interest rate as seen by Chile on its newly incurred dollar debt (or that part of the debt that is indexed to LIBOR).

When the dollar was very cheap and becoming cheaper in '79, dollar prices were rising very fast. You will see the real interest rate for Chile was 12 percent but negative. In 1981–82, the dollar was appreciating very strongly. The dollar prices of goods were actually falling, as you see in the first column, at the rate of 5 percent in '81. That was a year of high inflation in the United States, but dollar prices of Chilean traded goods were falling sharply in 1981, and even more so in '82, and Chile experienced a real interest rate of 24 percent. That's a swing of 36 points in the real interest rate.

One wonders how Chile might have avoided a debt service problem at that time. I find it very similar to the condominium boom in the United States indeed, almost identical. In the late '70s in most cities in the U.S., condominiums were appreciating very sharply, such that the real interest rate defined on condominiums was substantially negative. Condominium prices were rising about 20 percent per year or more, and one could borrow money at 15%. So if one could borrow a million dollars to buy a condominium, he could live in it free.

The only problem was the cash flow. One would have to come up with $150,000 in cash flow, but with appreciation at the rate of $200,000 a year, there was no difficulty getting second, third, and even fourth mortgages. Life was very pleasant.

At about the time that things changed for the developing countries (1980), the same thing happened to our condominium market. Prices leveled out. No more appreciation and have no more mortgages. Everyone was caught in a cash flow squeeze; indeed, we could have had the same discussion in that context concerning solvency versus liquidity as we have had in the international debt context.

The reason for this, of course, is the wild fluctuation in the U.S. dollar vis-a-vis other major currencies which Mr. Cline mentioned earlier in his presentation. It's remarkable what's happened. Since the dollar bottomed in mid-1980, the deutsche mark price of the dollar has risen nearby 70 percent, the Swiss franc price of the dollar has risen 60 percent, the pound sterling price of the dollar has risen 100 percent, even though in most of these countries the inflation rate has been lower than ours. The result has been a tremendous increase in real exchange rates.

The implication I think of that is that a lasting solution to this problem, and a means of avoiding it in the future, lies in doing something about the international monetary system. The instability of the international monetary system is one of the very important causes of the international debt problem.

Now let me turn to some question concerning debt service. I also treat that in the paper and I refer you to equation 7 on page 11, in which I work out the net debt service as a fraction of GNP, both measured in dollars. By net debt service I mean the trade (or commercial) account surplus which a country must generate in order to service its debt. Small "d" is the ratio of debt to GNP, "i" is the average interest rate, external debt, "g" is the rate of growth of the economy in dollars, and "d" with a dot over it is the rate of change of debt relative to GNP.

There you can see the importance of economic growth, which is important in contrasting Latin America with Korea and perhaps other Asian countries. Suppose a country can maintain its ratio of debt to GNP constant. That is to say, "d"-dot is zero. And suppose it could have a rate of growth of 8 or 9 percent, such as Korea has. Suppose further that it is paying 10 or 11 percent average interest rate. Then the term appearing in brackets in equation 7 is of the order of magnitude of 2 percent. If the debt is 50 percent of GNP, then the commercial account surplus that country would need is a mere 1 percent of GNP. That's essentially the story of Korea. Korea needs a very small trade surplus to finance its debt.

On the other hand, consider a country which is shrinking, negative growth, or at best a zero growth, which is certainly characteristic of most Latin American countries since 1980. Real output has fallen in most Latin American debtor countries since 1980. They face enormous debt service as a fraction of their GDP.

The implication of this is that the best thing these countries can try to do is to remove their internal barriers to economic growth and create a situation in which the banks will be willing to lend to them again. That is, to at least maintain constant the ratio debt to GNP.

Now there are many internal barriers. Brazilians are fond of arguing that their economic difficulties began with the Mexican default of August 1982. Some of those present here heard Carlos Langoni last January at the CATO conference say precisely that.

The fact of the matter is that the Brazilian economic crisis began in early '81, 18 months before the Mexican default, and was largely self-inflicted. It was brought on by a set of measures that resulted in real rates of interest of 40 to 50 percent, which, of course, were sufficient to cause Brazil's economy to decline through '81 and remain stagnant ever since.

The inflation is another contributing factor in many of these countries, certainly in Brazil. These inflations have come about mainly because of resistance to structual change. Much of the debt has been incurred to finance fiscal deficits and the banks have stopped lending for that purpose. The result is that the deficits have been financed by inflation. No one but the Brazilians, the Argentines, and the Mexicans can do anything about the problem of restoring internal growth.

Let me now turn quickly to some comment in the latter part of the paper about key factors in these countries' debts and then make some comparisons of Korea and Latin America.

I would emphasize three factors, one of which I have already mentioned—the differences in growth rates. Somehow, the Koreans are doing something right in keeping their growth rate up, whereas for the most part Latin America has failed miserably in this since 1980–81.

The second is the fiscal element—the extent to which external debt is a direct obligation of governments as opposed to private agents. Third is the vulnerability of countries to massive swings in external exchange rates; that is, exchange rates between the dollar, the pound, the mark, and the yen.

With respect to the fiscal element, in Latin America it's terribly important. If you look at the official data for Brazil, for example, you find no fiscal deficit. Indeed, in most years since 1967 Brazil showed a fiscal surplus. Nevertheless, they have to have inflation of 250 percent simply to finance the public sector fiscal deficit. The fiscal deficit in Brazil, of course, comes mainly from off-budget expenditures. They have an institution called the Banco de Brazil which is a perfect substitute for the U.S. Congress in producing fiscal deficits.

In Argentina, much of their deficit, which may be as high as 20 percent of GNP, is off-budget. It's an item called a "financial" deficit of the central bank, which amounts to 7 percent of GNP.

Chile is in pretty good shape, and Mexico has gotten itself in good shape. But the countries which are experiencing really serious debt-service problems in Latin America tend to be countries with substantial fiscal deficits.

The opposite is true in Korea. The current fiscal deficit is about 1.6 percent of GNP which, at a growth rate of 8% can be financed entirely by money creation without inflation simply because of the rapid growth in demand for real cash balances and hence the monetary base.

The importance of the fiscal issue is that it casts the debt problem internally in stark political relief. If private individuals have to contract their spending to service their debt, so be it. But when the government has to do it, it's a political problem. It could not be more clear that the Argentine debt service of 1984 is clearly a political issue, whereas the private sector debt service is not.

Finally, I would like to say something about the effect of changes in external exchange rates, which have worked so strongly against Latin American countries since 1980. They seem to have worked much less strongly against Korea and other Asian countries.

Inspection of some broad price indices for traded goods—and these are unit values from the IMF International Financial Statistics—for the industrial countries from 1980 to 1983, reveals that the dollar prices of goods traded among industrial countries fell about 11 percent. That's a direct consequence of this appreciation of the dollar since 1980.

The IFS commodity price index, which is also in dollars, fell 20 percent in that period. The unit value of traded goods for Chile fell an astounding 22 percent in that period, which means that their debt is 22 percent higher in real terms than it would have been had dollar prices remained flat.

For Korea, the dollar deflation was only 6 percent. That is less than what we had in the traded goods prices for the industrialized countries. Indeed, it may well be true that the appreciation of the dollar has been relatively beneficial to Korea. This is something about which I have not yet enough evidence to be really sure. It's still a working hypothesis, but it does seem that Korea's structure of trade, the fact that her export trade is largely in manufactured goods and much of it aimed at the U.S. market, may have permitted Korea to have a much less traumatic experience in this connection than many other countries whose trade, particularly export trade, is concentrated in commodities.

So we have a quite different situation in Korea and I think that this is probably true of the Pacific Asian countries in general, although I don't know enough about it yet to say anything that I can really defend.

In closing, I would like to emphasize that we have enormous differences among countries, even within Latin America, and particularly so when we look at Asia versus Latin America.

Some countries are basket cases. We have mentioned four already today—Panama, Costa Rica, Chile, and Bolivia. These are countries whose external debt is 100 percent or more of GNP. One simply cannot envisage that debt being serviced unless interest rates decline dramatically or unless somehow some write-off is

done. Those countries, I think, are beyond the pale of conventional solutions.

For other countries in Latin America whose debt is 30, 40 or 50 percent of GNP, I think it's quite possible for them to service their debt if they get their internal fiscal affairs in order. But it will not be possible for them to service it if economic stagnation continues and I insist that that economic stagnation has come about mainly from internal policies rather than external events.

Finally, if we really do want to do the world a favor in terms of this situation, I think that we ought to be starting to take another look to the possibility of international monetary reform. Thank you.

Mr. REIFMAN. Thank you. What do you mean by international monetary reform?

Mr. SJAASTAD. Well, I would envision a system which will prevent these enormous swings in real exchange rates or, in other words, enormous departures from purchasing power parity. We saw the dollar decline by rougly 50 percent from '72 to '80, and appreciate by up to 100 percent in real terms from '80 to '84. This is a wringer that the debtor countries have been put through and their timing could not have been worse. With the benefit of perfect hindsight, we see that they went into debt when the dollar was cheap and goods were expensive and now they have this enormous debt service when goods are cheap. As this is something that could not have been foreseen, you cannot blame either side, but it's something which we should learn from and try to eliminate in the future.

Mr. REIFMAN. I presume by that you mean you would have the U.S. change its mix of policies rather than what Jim Tobin has suggested, a tax on transactions to slow down international capital flows.

Mr. SJAASTAD. Personally, I would favor a return to an arrangement such as Bretton-Woods.

Mr. ROWEN. With target zones, is that what you're talking about?

Mr. SJAASTAD. Well, that may be a way of getting to it.

Mr. ROWEN. But some kind of fixed instead of fluctuating relationship with all of the problems that brings?

Mr. SJAASTAD. Well, I surely would like to be living with the problems of the '60s again.

Mr. ROWEN. I don't know that I would.

Mr. SJAASTAD. Compare that, to the problems of the '80s.

Mr. REIFMAN. Well, you opened up a whole big issue that perhaps we ought to let sit for a while.

Jamie, did you want to comment?

BASIC CAUSES OF THE DEBT PROBLEM

Mr. GALBRAITH. It is true, as Larry said, that I didn't have a copy of his present paper. I did, however, have a model to forecast it. The model consisted of what Sjaastad was saying in September. There were some offsetting errors in my assumptions and my forecast came out about right.

Sjaastad in November is shorter than Sjaastad in September and contains even less to disagree with than in the earlier version. So some of the things that I would have commented on are not relevant.

I see three essential points in what Sjaastad has been saying.

First, it is important to emphasize that there is a wide variation across countries. Only a few, the four just mentioned, are arguably in hopeless financial condition, and not incidentally that is also true of the banks. Only a few of them are exposed to a risk of nonsurvival.

Second, virtually all of the Latin American country problems, even including the hopeless ones, would become manageable if one could imagine a sharp drop in real interest rates which, under the circumstances, can only plausibly be achieved by a very large and rapid depreciation of the dollar because the other ways of doing so—with a sharp drop in nominal U.S. interest rates or a sharp rise in U.S. inflation—seem to be ruled out by the posture of U.S. policy.

Well, that would take care of virtually all of the major problems. The problems of the biggest countries—Argentina, Brazil, Mexico—don't require even that. All that they require to remain manageable is continued high OECD growth rates and a viable policy of export growth, on which point I gather Sjaastad and Cline are in substantial agreement.

The third point is that the dramatic increases in the real rate of interest on Latin American debt are due primarily, not wholly but primarily, to falling dollar prices of their tradeable goods, not per se to rising U.S. nominal interest rates, excessive borrowing and other factors, although obviously the question of what causes what is another point.

Otherwise put, it was OECD policies that created the condition for the runup in debts in the '70s and OECD policy that created the conditions for the crunch in the '80s.

Let me just comment on those three points. I think they capture the main things that you were saying.

Mr. SJAASTAD. Well, there was enough blame to go around.

Mr. GALBRAITH. Yes. I found myself in virtually total agreement with the first two points with respect to the variations of problems across countries and with respect to the degree of manageability.

I only note in passing this is a very brave analysis since it calls into question the urgency with which the issue is being treated in financial circles and the press, and indeed why we are taking a day off of our time to discuss it today. However, this view is not, by the standards of official thinking, an eccentric one. It's something that's very widely shared.

I only note in a digression that a comparable view of the U.S. budget deficit would be considered hopelessly eccentric.

On the third point, the question of the effect of rising and falling prices in tradeable goods of the small Latin American countries, I have a technical question which I would like to hear you address. And that is, to what extent does the level of tradable goods prices matter as well as the rate of change? To what extent is a country like Chile in a different situation a year after the depreciation of the dollar and the falling copper prices than when that deprecia-

tion is actually going on? The measure of real interest rate, quite obviously, would be quite different, but the difficulty of the situation might not be.

Let me turn briefly to the policy implication that Sjaastad drew from those three points, which is that the measures required involve, first, internal adjustment in the policies of the debtor countries and, second, measures of external stabilization that would prevent the kind of cycle that we had over the last decade from repeating itself, drawing people into debt in the first place and hanging them up on it in the second.

That mix of recommendations clearly rules out something else that's been on the agenda today, which is direct transfer schemes, at least as a measure of financial rehabilitation. They fail—I believe in Sjaastad's view—because of moral hazard a difference between the apparent and real recipient of the transfer.

I wonder about that a little bit, although I tend to agree that not much in accomplished by such schemes in real terms. I wonder whether a transfer mechanism which essentially bought up the debt held by the banks would not in fact clear the books of the outstanding financial encumbrance. That is, I wonder whether the analysis really follows: Isn't a transfer a transfer, whether it's a desirable one or not?

I would say, however, that the long-term problem is rather neatly framed, if not directly addressed by Sjaastad's paper, and that is how to create an environment which goes beyond the question of manageability of the debt. In other words, an environment in which successful resource transfers to the LDCs can be effected, permitting growth to resume at rates greater than might plausibly financed by exports less debt service.

To achieve that, it would appear to require (a) in the most severe cases, some means of clearing the old financial encumbrances off the books, either formally or informally. I would note that default is not a way of doing that since it only clears the encumbrances off the books of one party and not off the books of the other. And (b) establishing a political framework which permits removal of internal barriers to growth and within which new financial relationships can be undertaken, which is to say in which there's a reasonable relationship between net borrowing and economic investment.

The difficulties of the first, the financial workout, speak for themselves. Probably the only way to achieve them is through a sharp drop in real interest rates as perceived by developing countries as Sjaastad says. That, it would seem to me, would require perhaps the return of the ghosts of Samuel P. Chase and William Jennings Bryan to the Federal Reserve. I'm not sure what kind of bet I'd care to make on the likelihood of that.

With respect to the second, it seems to me that establishing the political framework for renewed growth requires a little more attention. It would appear—I am not an expert on Latin America, but it seems reasonably clear to a casual observer that military governments in the region have run or are in the process of running their course. Therefore political transition is very much in the air. Colonial arrangements and the old methods of establishing long-term stability have not been available for a couple of centuries. Therefore the alternative is to move to the establishment of

43-427 O - 85 - 3

constitutional democracy as the only form of government with serious prospects for long-term stability.

That seems to be the only hope, however distant it may be in particular cases. It's possible that that cannot be done. But it would seem to me that if there is a way in particular, to help the Argentines in this effort, then at least in that case and maybe a few others there is an argument for taking a prudent economic and foreign policy risk.

Beyond that, the question comes up, what is the role of the U.S. Government? I think Sjaastad's argument provides a clear answer, which is that there is no real case for aid to the countries to facilities purely financial transactions in advance of some means to assure that the net flow is positive. Or to put it another way, the United States should simply stay out of the bank-country negotiations that may be going on. I believe that to be sound advice and one hopes that advice coming to the Reagan administration from the University of Chicago it wouldn't fall on deaf ears.

Mr. REIFMAN. Thank you.

Bill, did you want to say something,

Mr. CLINE. Yes. I think it's a very stimulating analysis. It raises some questions. For example, what is really the driving force in causal terms, as opposed to things that are simply happening at the same time. The debt to income equation immediately gives one the conclusion that all you need to do is have faster income growth and I guess everyone can agree to that, but it seems to me that often the driving variables are on the other side of the equation: the balance of payments constraint or the so-called transfer problem, is constraining growth.

Take Mexico. Mexico was charging along at 7 or 8 percent growth in the late 1970's and early 1980's and the standard diagnosis was that Mexico's economy was overheating, that it was borrowing too heavily, etc., and when it suddenly faced a transfer problem or a foreign exchange constraint once again its growth plummeted to zero percent.

So it's a little bit strange to say that Mexico could solve its debt problem if it would simply have rapid growth. Mexicans would say, well, we completely agree but the foreign exchange constraint is what's currently holding us back.

So I think while, sure, it's going to be all to the good to remove other distortions to growth, I think that's a little bit incomplete in diagnosing what the real constraints are. Incidentally, the fact that there is a transfer problem is the reason why one can't simply look at debt to GNP ratios. One also has to look at debt-export ratios.

Again, the emphasis on fiscal problems I think is useful, but it's a bit misleading again, because it suggests, although Professor Sjaastad didn't really put it in these terms, that the problem is basically a domestic problem, since we think of the fiscal problems as being a question of domestic responsibility.

The fact is that 30 or 40 countries all got in trouble right in the 1981–82 period of international recession, which was worse than any since the 1930's, and in any scientific test one would have to conclude that there were international factors at work. The problem wasn't that these countries all suddenly got fiscally irresponsible.

So again, I think that while granted fiscal deficits are an important factor, one doesn't conclude from that that the problem has been basically—certainly not solely a domestic problem.

The methodology of using the real interest rate as seen from the eyes of country "x" is interesting, but I think again it is unclear as to whether that's the only way to look at it.

One thing it indicates to me is the difference between short-run liquidity and long-run solvency because certainly when you say that the real interest rates switched from minus 26 to a plus 12 or whatever it was, these are very short-term developments. That's precisely the kind of thing that results from cyclical fluctuation in the commodity price. So that's really not a particularly meaningful real interest rate. Presumably, you want the expected long-term real interest rate and the ex post short-term real interest rate is an exaggeration of what's happening to the long-run real interest rate.

There are also conceptual questions. What about opportunity costs? From an opportunity cost standpoint, in a sense, we ought to be looking at global dollar prices rather than what the particular country happens to produce. It's a little partial to argue that, just because a country is producing copper, the price of copper is the right deflator.

Professor Sjaastad's analysis also emphasizes the dollar exchange rate as a determinant of the real interest rate facing the country. While I too consider dollar overvaluation to be a severe problem, and my analysis especially incorporates it, forcasting the dollar problem through the prism of the real interest rate tends to downplay the problem of excessive real interest rates even within the United States, and the problem of fiscal-monetary mix. Sjaastad's approach tends to say that the problem of the high real interest rate is the fact the commodity prices are depressed (in part because of a strong dollar), whereas it seems to me that there's another very major component of the problem of high real interest rates and that's the U.S. fiscal-monetary mix of tight money and loose fiscal policy.

On another issue, I'm not sure I heard you correctly, Larry. Did you say that Chile was one of your basket cases?

Mr. SJAASTAD. Yes.

Mr. CLINE. I would disagree with that. My projections for Chile in my book are too optimistic, but even using a lower copper price (and I have done more recent projections), Chile's situation appears manageable to me. Certainly if there is a surge in copper prices, which is not unlikely once the dollar goes down and interest rates back off, the situation can change radically. I would make that a more general comment—these diagnoses that country "x" is a basket case and should have a good portion of its debt forgiven can be very quickly outdated by events, such as the next Brazilian coffee freeze and a surge in coffee prices.

Mr. REIFMAN. Thank you, Bill.

Mr. KRUGMAN. I wanted to say something about what I thought this paper was more about which was the Brazil-Korea problem, why is it that Korea, with a debt burden by some measures as large as Brazil's doesn't have the same problem? That is, what is the difference between Latin America and Korea?

As Bill Cline noted, this paper simply uses the rate of growth of GNP as the critical factor. It seems to me it's very misleading to use it that way. If there's one thing that we should understand now, it's the difference between aggregate supply and aggregate demand and between growth in output and growth in potential output. You don't want to say that if a country is put in a recession because it's cutting imports in order to meet a balance of payments constraint that that thereby reduces its long-run ability to sustain an increase in debt and therefore its ability to borrow. If bankers start to see things that way, it's going to be a very unstable world. Maybe to some extent they do, but I hope they realize that at least part of the causation runs the other way. You expect a banker to look at the long-run growth potential of the country and presumably the potential output and not the short-run cyclical outlook.

It's clear that Korea has a big advantage. Their long-run potential growth is probably two or three times as great at the Latin American countries, but to contrast the negative growth they have had as a result of their financial constraints with the growth that Korea has been able to achieve because it hasn't been impacted so much seems strange.

Now let me move to a serious discussion. There are two kinds of people who talk about relative prospects of countries. There are people who are subtle qualitative people and there are people who are crude quantitative people. The subtle people go out and say, like President Reagan, that there are all different countries and discover that there are lots of differences you really have to look at, such as the political situation. The crude people try to look for some crude indicator.

I am a crude quantitative person, mostly because I don't think we're very good at the subtle qualitative stuff. In 1982 and 1983, I went to a number of meetings where people argued persuasively "never mind the numbers, look at the political systems, and you can see that Brazil is going to bring its problem under control quickly and easily while Mexico is never going to make it." I have become very skeptical about the kind of analysis that goes into that and my usual inclination is to start with whatever crude quantitative thing we can get our hands on, at least to clear that out of the way. Those are the things we can understand.

If you look at this issue—Brazil vs. Korea, Latin America vs. Asia—you ask what is the crude quantitative difference or what crude quantitative difference is going to be distinguished, you find that the debt to GNP ratios are in the same ballpark and a lot of other things like current account balances before the crisis are also in the same ballpark. External shocks, if anything, as measured by terms of trade and so forth are for some of the Latin American countries more favorable than for the Asian countries.

The one thing that stands out overwhelmingly is that the debt-export ratios are widly different. Korea had a debt-GNP ratio which before devaluation was considerably higher than some of the problem Latin American countries, but had much lower debt-export ratios because it was so much an open economy.

So my first inclination is to suppose that part of the answer is that having a big ratio of exports to GNP is good for you. So the

question is, why does that make you more able to sustain a larger debt burden as percent of GNP?

There are at least two stories, both of which have got to be at least partly true. One is an adjustment story and the other one is a hostage story.

The adjustment story says that if somebody demands you improve your trade balance by "x" percent of GNP it's a lot easier to do if you start with exports at 47 percent of GNP than if you start with exports at 8 percent of GNP, and in that sense to the extent that a debt crisis requires rapid improvement in the trade balance it's easier to do.

The other story which goes more to the long-run issues is the hostage story. Overwhelmingly, the onset of the crisis was a matter of confidence on the part of banks—a feeling that the sanctions that might lead countries to service their debt might not be strong enough to actually induce them to do so in the future. Now the main sanction against countries not servicing their debt is the obstruction of their trade in goods. A country which has open trade and becomes freely dependent on trade is more vulnerable to such sanctions; because it's more vulnerable it's also more reliable and therefore it is less subject to loss of creditor confidence.

If you try to imagine Korea repudiating its debt, the consequences for the Korean economy would be incalculable. If you tried to imagine Brazil repudiating its debt, the consequences would be serious but not incalculable, and that makes a big difference to confidence.

Of course, they are different countries and there are a lot of things going on, but I think that just looking at the very crude things gets you a long way.

Mr. REIFMAN. Thank you, Paul.

Larry Sjaastad, I want to ask you and Bill Cline about your argument that the problem ought to be taken care of bilaterally between the debtor country and the banks and let the banks take their losses.

Cline's book argues that this would create a real problem for a large number of banks. Am I misreading the numbers?

Mr. CLINE. If you had a widespread default, sure, you could cause all kinds of troubles for the banks. There's a prior question as to whether the situation is that bad. I would be very interested in hearing Larry Sjaastad's views on the role of the public sector as sort of midwife or facilitator to this transition period of working out of the debt crisis.

Mr. SJAASTAD. Well, my views have already been expressed by Galbraith, but I think probably that is one of the hazards, although very difficult to assess. I think that involvement of the U.S. Government in what is basically an eight-bank problem, viewed from one angle, or an eight-country problem viewed from another, does raise the spectre of moral hazard. It's difficult to assess because if we did work out a bailout scheme of some sort, some bankers have assured me privately that their expectation is that Congress' conditions for so doing would be tantamount to nationalization of the banks. That's a different kind of relationship.

I would question the default risk, however. I think default is the least likely outcome as it is in no one's interest to default. The

banks don't want a default. The countries don't want to default. If we leave them to their own devices, I think they can work out a write-down, say in the case of Chile, that it is manageable, and that is what will come forth. One can't rule out default if further developments in Argentina result in a hyperinflation, but I think it's the worst outcome from both parties' points of view.

I don't think that we're really facing default as long as we stay out of discussions between the countries and the banks and let them deal one-on-one to get the debt service down. In some countries a write-down is essential; I see no way, for example, that Panama can service its debt. Panama has to pay out 10 percent of GNP for the foreseeable future without a write-down, and I don't think that's viable for more than a few years. Similarly in Chile, I don't think it's viable and I wouldn't stand around waiting for a revival of copper prices. Even if there were a major decline in the dollar, I don't think that Chile will participate very much in the benefits of it.

Mr. CLINE. Well, as I hear your policy prescription, I'm not quite sure I see how it differs from what we're doing. Yes, the Treasury made loans. I like the way the Treasury lent money back in '82. They lent I think $1.2 billion to Brazil for 90 days or so. I was thinking, I could be the world's biggest benefactor if I lent $5 billion for a tenth of a second. It was very short-term money. We haven't really seen very much public money going into this. So I think your prescription is pretty much what's happened. In fact, we are even seeing public pressure, as opposed to bailouts. I think the recent downgrading of Argentina to substandard by the U.S. bank regulators is a pressure on the banks to come up with the money and a pressure on Argentina to reach an agreement with the banks under the threat of a subsequent downgrading to a value impaired status which require costly loan-loss reserves.

You don't seem necessarily to be ruling out the kind of more indirect, systemic, sponsorship role as opposed to direct bailouts, in terms of having an IMF in existence and having the IMF have the necessary resources to make what amount to adjustment loans that are somewhat longer-term but still not terribly long-term development loans. At the same time, I completely agree that we don't want a new international institution where the public essentially picks up the tab for a 20-percent write-down on the debt. In sum, I'm not sure how much your prescription really varies from what we've been doing.

Mr. REIFMAN. Let me interpose. I thought Bill was going to say something different from this. Since he didn't say what I wanted him to, I will ask him. In your earlier writings, Bill, you talked about the impact of a one-year moratorium by the three large countries. What would it do to the banks? Have you changed your view on what this would do to U.S. banks?

Mr. CLINE. No, I haven't changed my views on that. I think the point is that the probability of that happening is rather low and if you're talking about write-offs it tends to be much smaller cases, as Larry was suggesting. With respect to the issue of potential bank losses, it seems to me there is a tradeoff between moral hazard and systemic shock. Certainly, in abstract terms, mine is an element of moral hazard in having the system stand ready to avoid bank col-

lapse. Nonetheless, it is difficult to imagine the economy going right on with no ripples if suddenly the nine largest banks were insolvent or there were runs on the banks. I don't think Larry is suggesting that we should flirt with that possibility.

So I guess the point is that that's why I mentioned potential for damage if there were a very widespread default and even a very widespread long-term moratorium, but I don't think that's where we are. You're not suggesting, are you, Larry, that even if it meant the collapse of the nine largest banks that it would be good public policy to maintain a totally hands-off policy?

Mr. SJAASTAD. Well, let me respond to that. First, the write-offs would be small. If you take Latin American countries that are in trouble, one can't imagine that the write-off would have to be more than 40 percent, and that's already probably two or three times as large as one that's likely, but let's take 40 percent as an upper limit. Only one bank probably wouldn't survive.

Mr. REIFMAN. Continental Illinois or which one?

Mr. SJAASTAD. Continental Illinois went down by its own hand. It didn't go under because of foreign loans. Bankers don't have to get into that business to make stupid decisions.

One of the banks may go under. The rest would have to contract because they would lose a substantial part of their capital, but I don't think the world would necessarily be an impossible place in which to live if we didn't have Chase Manhattan. But I can't imagine that more than one bank would have to go into receivership.

Of course, even if they did, the world's supply of banking services would remain quite substantial as we have some 15,000 banks in the United States. The lesson of Continental Illinois is that this sort of thing can be done without causing panic. At Continental Illinois there was a collapse without a panic. Of course, it could have caused a panic. We can always mismanage these things sufficiently to create a run, but I am much less worried about a run—and I think Paul Volcker isn't all that worried about a run. I recall some years ago in a meeting in Vienna, Paul and I and several other people were having a beer and someone raised the issue of what would happen if the Arabs or OPEC pulled out $5 billion. Paul just growled and said, "Where would they put it?"

So a run against one bank just puts money into some other banks. The only thing that the Fed has to do is to recycle it back to the first bank, and that can be done with the speed of light. People aren't going to take out a couple hundred or $400 billion and put them in the mattress. It's going to go straight back into the banking system to be recycled, as was done in case of Continental. There's no logical limitation on the size of that operation.

Mr. REIFMAN. Could I ask Ted to comment on the speed of light?

Mr. TRUMAN. It's 186,000 miles per second. [Laughter.]

I think I would accept the general proposition that the money is not going to disappear and I think Larry's remarks suggest that even if one doesn't go as far as he did and suggested that it's not a foregone conclusion that it would be managed smoothly, or words like that that he used, and so one though I think reasonably wish that you didn't run an experiment on quite that scale, you might be at the speed of sound rather than the speed of light and that

probably wouldn't make much difference either as long as people talked fast.

I think the issue here—it is not entirely clear from what he said—what was the phrase—whether he is being critical of nurturing—what was the phrase he used—midwifery is role of the public sector. There is a wide range of public sector involvement at the level of minimal sponsorship, a neutral word, from the involvement of the public sector in the operations of certain international financial institutions, on the one hand, to at an extreme of using directly for this specific purpose in these specific cases, rather than through general mechanisms, new appropriated funds to take care of whatever set of countries or subset of countries you wanted to deal with—whether you call it Marshall plans or new international financial institutions. There is, it seems to me, a spectrum that one has to deal with and, in fact, one could, I think, reasonably differ about where one is on the spectrum. Even to the extent that one says—maybe precisely for moral hazard reasons—in principal, hands off, one must be sure "hands-off" doesn't imply "head in the sand," if I could put it that way, because you might want to start generating operations at a minimum at the speed of light to deal with the consequences.

In a sense, you have to believe that the world is not going to end because of the international debt problem. The world might well be very different and many things might well be changed as a result of that problem, but somehow the chances of it setting off the big bang, so to speak, strikes me as unlikely. However, that's not saying you want to ignore the problem entirely or completely take an extreme laissez faire approach of live with the consequences of something short of a big bang.

Mr. SJAASTAD. Could I respond to Mr. Truman's remarks?

Mr. REIFMAN. All right. I know you have to go shortly so that's fair enough.

Mr. SJAASTAD. Someone raised the issue of the U.S. budget deficit. If something isn't done about it I can readily imagine that sometime within the next decade we will be meeting in Rio or Santiago or Mexico City to discuss the external debt problem of the United States. We are clearly digging a hole for ourselves.

With respect to Galbraith's question concerning level versus rates of change, there are two ways of looking at it that are equivalent. One is to look at it in terms of what is going on with real interest rates over the period during which exchange rates have changed and that's what is presented in my paper. That tells you what would be the consequences to the country if they were actually paying the real interest rate.

The other way is to say they are paying the nominal rate but after the exchange rates occured between the dollar and the other major currencies their debt has gone up by the amount of cumulative excess of real over nominal. So these are merely two different ways of looking at the same thing.

With respect to Mr. Cline's comments. I think the way I'm comparing more than saying growth is the solution for a particular country. That tells you a lot about looking at a stagnant economy versus a growing economy and hence there are growing economies

that will probably keep their debt growing with the GNP whereas the stagnant economies probably do not.

With respect to Mr. Truman's comment, I don't think it's correct historically to say that the decline in the Latin American economies occurred because they faced a cutoff of lending. In country after country after country and it started in '81, Argentina, Chile, Brazil, and Mexico all began to decline in '81. The really stringent aspects of the financial cutoff didn't come until '82 and became much worse in August of '82. Money just stopped flowing when Mexico came to de facto default. But I think that these recessions or depressions were caused to a large extent by internal factors which have been aggravated by the subsequent balance of payments constraint.

With respect to the other comments concerning debt-export rations, here we have to be a little careful. It's my impression, although it's very hard to get a clean estimate of it, that in the Korean case, for example, there's an enormous amount of import context in her exports, much more so than in the Latin American countries. Argentine exports are almost 100 percent domestic value added. Brazil is very high. Chile is very high. But even when you look at exports of domestic value added, there's still a gap because Korea is much more open.

Finally, with respect to what we should be doing differently, I'm glad we can fight about this a little bit. There isn't that much. I agree with you. I'm saying let's muddle through without creating new institutions and so on.

There is one thing I would do differently and that is I would rethink the SAL of the World Bank, the structural adjustment loans. One thing we can be very certain that structural adjustment loans will accomplish and that is to postpone structural adjustment. What those loans are doing is making it almost certain that there's no structural adjustment. As long as we continue to finance the imbalance they have, one can be very sure these guys aren't going to do anything about it—except cheat, of course, in their reports to the IMF and the World Bank.

Mr. REIFMAN. Ann, shall we let him get away with that?

Ms. KRUEGER. Well, it's not really cheating, but it's a difficult line because obviously you can get situations where additional lending simply perpetuates the status quo and you can also get situations where the political process either cannot or where the political process either cannot or will not give enough to make a difference. Judging those cases when it will give enough and what that minimum is, is hard work and I don't think the Bank has always been right and I think the Bank knows it.

Having said that, though, given political resistance, there are also occasions when it is possible to finance or induce moves that otherwise wouldn't occur or would occur only much more slowly. So I think Larry is quite correct in saying that sometimes it doesn't work this way, but I think without some institution somewhere in the system pushing in the direction of adjustment and then correctly calling when enough is enough and how fast it is and so on, that there would be even more problems than there are. So SALs,* like

*SALs are structural adjustment loans.

anything else, could be used or abused. The past four years have been incredibly difficult ones, and effectiveness of SAL changes cannot be judged only on countries' performances in the past few years.

Mr. REIFMAN. Thank you.

Let's hear from New York and from the Bankers Trust, Larry Brainard, Senior Vice President of Bankers Trust. I'm glad this bank was not the one you expected to go under.

A BANKER'S VIEW—BY LAWRENCE BRAINARD, BANKERS TRUST

Mr. BRAINARD. Thank you. I should emphasize, although I have been put on the program as someone who is reflecting the view from New York, there are many views. As we like to say about ourselves, we're the best of the worst. So if you talk to the worst of the worst, you might get a different perspective on some of these problems.

What I'd like to do first is to sketch as I see it the kind of environment we are facing; this may help inform the discussion.

I'd like to start with the point that Larry Sjaastad mentioned because it's absolutely essential in understanding how bankers are thinking about the world outside. That is simply the instability in the international financial system has to be viewed as a major factor leading to caution and conservatism in international bank lending.

We have had discussions about what happens if the dollar falls with an implication that interest rates might fall. I'm not convinced of that. I think, depending on the circumstances, interest rates might go very high. The point is, we simply don't know. There's tremendous uncertainty about interest rates today—whether they're going to go down further, which would be a positive factor for international debt adjustment, or perhaps, if we're going to see yet again a very substantial rise of interest rates due to concerns about U.S. budget deficits.

We have the issue of oil prices. Are oil prices going to stick where they are now or are they going to go down a couple dollars—which we probably could live with, or are they going to go down six or seven dollars? We're not very comfortable with any of the scenarios we come up with.

Take the issue of low commodity prices. If we look at the world today as lending institutions, particularly thinking about committing funds for the long term, what impresses us is the instability of these prices. We must protect our capital against this instability; that's why we don't derive very much comfort from long-term projections such as William Cline has presented this morning. We have nothing against projections. It's simply that in setting our policy, we don't look for the median of a set of econometric projections. We look at the extremes.

As an example, we assume that either we're going to have a very strong dollar or a very weak dollar. We want to be safe within those extremes. This affects the kind of business that we want to do.

The bottom line is the feeling in financial markets that governments are unwilling or unable to deal with underlying problems.

We don't, for example, expect a solution to the U.S. budget deficit. We expect some sort of muddling along, but the muddling is such that when we create one disequilibrium, we respond to it by creating yet another disequilibrium. We had the initial disequilibrium caused by oil prices, which then led to the disequilibrium of excess lending, which has now led to the disequilibria of the domestic budget and trade deficits of the United States. If you're projecting a couple of years, not to mention 1990, or even 1996 in the case of Mexico's rescheduling we simply cannot have confidence that the system is going to stick together to allow us to continue to function with our capital unimpaired.

As a result banks everywhere—and this is not only U.S. banks but also foreign banks—are reassessing the criteria for lending and the nature of the lending that they do. This makes banks very cautious and conservative in thinking about their world.

The second element which has been touched on lightly but needs to be emphasized is the regulatory environment. Banks are regulated institutions and the regulatory environment is a factor that we have to take into account. There are two aspects of the regulatory environment, namely problems and opportunities.

The regulatory environment is changing in a way that is creating new opportunities for banks. Whereas during the 1970s we saw opportunities in foreign lending, now many of the banks are seeing opportunities in other sectors of the financial system—interstate banking, capital market activities, merchant banking and so forth.

There are different kinds of opportunities on the horizon today and these new opportunities are by and large domestic rather than international focused.

The second aspect is that the regulators feeling that they missed the boat in the seventies in getting tough with the banks on foreign landing—are now getting tough with the banks. I think it's good for the system. It's going to be hard for all of us. We are under strong pressure to increase capital. The issue of how much capital banks need is a critical issue that hasn't so far adequately been addressed.

Many banks are under pressure to take more forthright actions vis-a-vis write-offs. Initially, this seems to be focused on domestic loans, given the reaction to the Continental Illinois Bank situation. I don't think it's too long before banks will have to take a similar look at international portfolios as well.

Given this new regulatory environment it's hard to go out and ask banks to start lending again to a region or a particular country after banks have just taken substantial write-offs.

Several other comments are important understanding conditions under which banks might begin voluntary lending. They relate to the viability of the rescheduling process, in particular how well are the banks' interests being maintained in the rescheduling process.

The basic formula of sovereign lending was that banks lent money but had no control of the borrower; the control or discipline was to be provided by the IMF. Such a rule was never explicit. In the rescheduling agreements that we have now, it's clear that the banks do not see themselves as being in the position to impose conditionality on the debtor; that role falls to the international organizations.

If we were to look at a domestic bad loan situation, what usually happens is that we would go into the company, work out a new program, perhaps put in new management. If we take that parallel to the sovereign lending area, it's clear that it doesn't fit. In sovereign lending we're in a business where we lend our money and then don't have any control over the money after it's gone. I think banks realize the there are very strong inherent disadvantages of this type of involvement.

Some banks feel more comfortable in the political arena than others. Many banks, not just the regional banks, feel that this type of lending is something they never should have gotten into in the first place and don't want to get back into in any major way, at least, in the future. This is because this business is now political. If it is economic, it's secondarily economic. It's primarily political.

It's clear that the IMF has had an indispensable role in these problems and increasingly the World Bank is being pushed forward in the area of medium term structural adjustment. At the same time, we see a strong political backlash to the IMF. In Mexico there was strong pressure to get the Fund out. Yugoslavia recently asked for identical terms to Mexico. Brazil is expected to follow in the same line. We haven't as yet come up with an alternative to IMF conditionality.

In Mexico a modified Article IV conditionally was agreed. But this is in no way a solution. If the IMF discovers that things are going wrong and says so, then it triggers exactly what it doesn't want to happen, i.e. capital flight. If the Fund doesn't say that things are bad when they are, then they've lost all credibility.

What are some of the other issues that need to be understood concerning bank lending policies? One is the question of the law of averages and herd mentality. These state that all banks in any particular country look to see where they stand with regard to their peer group before acting. In the case of Mexcio, for example, some banks have exposure that is high relative to other major banks. Their goal may be to reduce exposure to the average. If things are going well in Mexico, these banks might reduce exposure so as to be less visible to the stock analysts, the regulators, the board of directors, etc. It's hard to see how lending can go forward on a voluntary basis with the kinds of increases which have been suggested 5 to 7 percent. And this assumes a best case scenario.

The second point is simply that there's not a single country in Latin America that would qualify for new lending today or perhaps even for the forseeable future. The risk ratios are too high. If we used the ratios in Korea as a benchmark, an acceptale country for sovereign lending, we're talking about a debt-service ratio of 25 percent. Net debt-to-export ratios of about one. In Latin America net debt-to-export ratios are in the range of 3 to 5, and even on the most optimistic assumptions they're not going to get down into the desirable range for the rest of this decade.

The third point concerns governments. Banks feel that where the governments are not seen to be playing a role in assisting country adjustment, the case for the banks continuing to support the process as it now exists is weakened substantially.

In the case of Brazil the banks went into a new money facility last year on the basis of a $2.5 billion official credit commitment to

Brazil, which in fact never materialized. There's a tremendous sensitivity, therefore, to the concept of burden sharing between the governments and the banks. This is perhaps more a perception than anything else, but it's important.

Where does this leave us? First of all, I don't think there's any question that banks are willing to reschedule principal on flexible terms, provided no new money is being requested. They have relatively little choice to protest such transactions, though even in the case of the Mexican rescheduling the terms may have been too flexible for some banks.

Situations where involuntary lending is required appear very problematical. The Philippines and Argentina have both requested large new money commitments from the banks; Chile and Peru will each likely require new money in 1985. There is a growing resistance to such types of involuntary new money. The banks realize that in these situations the economic problems are linked to political constraints. As a result the banks are caught up in the domestic politics in each of these countries; not only do we have the challenge of coming up with new money, we also are dealing with countries where the political prospects appear most difficult to forecast.

Banks will continue to explore traditional kinds of finance such as trade financing, and project-related financing where there is security tied up with the asset being financed. But a revival of unsecured sovereign lending is not around the corner.

Hence, any of the scenarios which depend on a revival of voluntary lending by banks would not appear to be high on the list as being the most probable. What are the other options? One possibility already hinted at is the model of medium-term structural change, primarily domestic structural change as Professor Sjaastad mentioned connected, perhaps, with the World Bank through its SAL program. This approach is being developed in Costa Rica and Chile.

A second option is to substantially increase government assistance—assistance in the form either of direct government lending, increased facilities for the international institutions, or perhaps various kinds of off-balance sheet guarantees on the part of governments the banks who do the lending.

There's another option which hasn't been addressed here. That's the option I call instability and revolution. I think this option results from doing nothing about these problems.

Mr. REIFMAN. That last option was not something which the banks would choose I assume.

Mr. BRAINARD. No, no.

Mr. ROWEN. Did you say evolution or revolution?

Mr. BRAINARD. Revolution.

Mr. REIFMAN. It loses in translation. Thank you very much, Larry [Brainard]. That's a very sobering commentary after the optimism we've had.

John Henderson, do you want to comment?

Mr. HENDERSON. I might make a comment. The astringent view that Larry Brainard has presented causes me some trouble. I hope it won't be considered unfair to quote from a previous article on Third World Debt by Larry Brainard: "The path to sustainable world growth, lower interest rates and rising levels of trade lies in

the old-fashioned virtues of conservative fiscal management combined with reliance on free markets."

The reliance on free markets I guess doesn't include the one-on-one negotiation suggested by Larry Sjaastad. In fact, your concluding remarks seem to suggest new forms of government assistance. But I find the difficulty is the tremendous difference between that quoted sentence and the problems presented by Sergio Amaral and Miss Bindert this morning.

The ideas that they presented were essentially that it was impossible to dissociate the resolution of the Latin American debt problem from the political environment. If the private banking system of the United States and the Western World is going to choose its options in this way, it has also to address the question that was raised this morning, to what extent is that going to be a resolution that includes the necessity for continued flows of credit as the basis of continuing growth of the Latin American economies?

The difference between the two approaches seems to me a very big problem indeed.

Mr. BRAINARD. Let me just clarify that point. In the statement you quoted, what I'm trying to say is that the option of medium-term structural change is the one which consists of internal adjustment of policies, more efficient allocation of resources, less government involvement in the domestic economy in these countries, more support of the private sector in the sense of less interference and greater use of free markets within these countries.

Mr. HENDERSON. But still you have a situation in which the banks do not feel themselves to be in control.

Mr. BRAINARD. This result is not something the banks themselves can bring about.

Mr. HENDERSON. But if indeed the loans have been used for financing government deficits and also have been accompanied by capital flight in some cases, then conceivably the banks are not going to be interested in participating again in certain sections of the world.

Mr. BRAINARD. I wouldn't say that. The way things are now, yes, I think it's unlikely that you're going to see a spontaneous revival in lending. If we focus and work toward medium-term structural adjustment that includes all of those elements, I think that one can lay the basis on which banks could resume lending. That's my basic argument.

The conclusion of my article, which you didn't quote, is that these kinds of changes are not imminent in any of these major countries. I don't see Mexico, for examples, turning around tomorrow and changing their foreign investment law or their discrimination against the private sector. The same is true throughout Latin America. I agree with Professor Sjaastad that there has been insufficient emphasis on how far out of line domestic policies are in many of these countries.

Mr. REIFMAN. Jamie Galbraith.

Mr. GALBRAITH. I have just a brief comment.

As I understand your argument, the commercial banking sector will not come back into net new lending for a very long time and particularly not in advance of substantial new official involvement

or assistance. I think it's fair to say that the same thing is true of anything that would require authorization from the U.S. Congress.

Mr. BRAINARD. So we have the options narrowed down to two then.

Mr. KRUGMAN. What I thought you were saying is that it's not going to come voluntarily, which goes back to Mr. Amaral's point made this morning.

Mr. BRAINARD. If you're talking about involuntary lending, you're not talking about a market. Essentially you're talking about de facto reduction in the flow of resources one way or the other.

Mr. TRUMAN. What I hear you [Brainard] saying is that there's not going to be a quick return to substantial voluntary lending.

Now you can draw two conclusions from that. First, is that some form of involuntary lending, if you want to put it that way, or continued loans on a fairly global scale, is going to be with us for an extensive period of time. If you just dress that up a little bit, and maybe go beyond what you were saying, this whole process has been on that side, on the financing side. It's not behind us, although maybe it's off the front pages.

The other conclusion—and this is a theme that I think has been present throughout this seminar—is that as far as borrowing countries are concerned, although there may have been in some cases substantial change, most progress has been made on the external side. I think almost all of the comments have suggested, while not saying things have to be absolutely perfect or things have been going better and will be going more normally, there's going to likely have to be a continuing process of structural adjustment, as you called it, before one sees any kind of return to substantial voluntary lending.

Now that in and of itself, as was indicated by Mr. Amaral's comments earlier and Miss Bindert's, is problematic, maybe even more problematic from the borrower's side. You likewise have, on the creditor's side, the problem that once the debt problem goes off the front page, then Congress doesn't have to worry about it any more or feels it doesn't have to worry about it any more.

So, likewise on the borrower's side. Once it goes off the front page, then structural change can stop. I put you right in the middle here; what you're saying is that neither side is correct and the process has a number of chapters yet to be written before one can say reasonably that much of what was started a number of years ago now can be simply played out.

Mr. GALBRAITH. Just a quick response to Ted on your calculation of Congress. I didn't mean to imply Congress wouldn't worry about it. I think Congress does worry about it a great deal and has shown that it will act where a plausible case for action can be made, such as securing the IMF quota extension last year.

The problem that Congress faces is that it is impossible for Congress to dissociate the international assistance from the domestic fiscal problem. It's all appropriated money and as long as we face that domestic problem we are incapable of making a great allowance for new resources on the international scene.

Mr. REIFMAN. Richard Feinberg.

Mr. FEINBERG. I just wanted to underline one or two points that Larry [Brainard] made because I very much liked his presentation.

One was the emphasis on the politicization. The way I understood Bill Cline's presentation, he also emphasized the role the public sector has played in this workout period, but then he seemed to be tilting toward Larry's point of view that I think is a misunderstanding of the role the public sector has played. Ted Truman very quietly and correctly also emphasized the role the public sector has played. By public sector, we mean industrial country governments, international institutions, and governments of the LDCs. And I would argue that all three of those have sharply increased their role in international finance over the last three years.[1]

That raises the question of the pessimism on capital flows from the banks that Larry really emphasizes, and what's striking there is that the causes for the decrease in capital flows seem to be things that the LDCs can't do much about in the medium term—the instabilities of the international financial system, the new openings in domestic credit markets, interstate banking, etc., and the debt-service ratios are so bad that even the improvements that Bill Cline seeks are not going to be enough to really turn the banks around in terms of their basic thinking.

There are two implications there. One is that this net capital outflow is more than some people projected, that they may have conceptual weaknesses but nevertheless on a cash flow basis it's there and it's certainly there in terms of the perceptions of the LDCs which is important. That's going to continue for a long period of time unless interest rates drop very substantially.

It raises the question that Jamie raised about official flows—will they come in? On the one hand, it's even less likely they will come in without bank lending because the argument would be this is a bailout. Nevertheless, I would be less pessimistic that it's impossible to turn Congress around. I think the way to turn Congress around on this issue is to make the security argument—not the international financial argument but the security argument. I think the Reagan administration has done this very successfully in Central America. Who would have thought that the U.S. economic assistance in Central America would be up to $1.1 billion per year, which is the current case, and it has been justified by a security argument.

The problem with making that argument right now is that contrary to the expectations of a lot of political scientists, the major debtors remain remarkably stable politically. This is a big surprise to a lot of people. Not that some governments haven't fallen, but basic political systems haven't been overturned. As a result the security argument is hard to make and the State Department therefore has been very weak in terms of carrying forward the argument of the U.S. Government.

To pick up another point that I think Larry made which is extremely important—the political backlash against the IMF. The countries want to get the IMF out—we all think they're doing a great job but they haven't really won a lot of friends in the Third World. But that's over the dam. The issue now is the World Bank.

---

[1] See my article in John Sewell et al., U.S. Foreign Policy and The Third World: Agenda 1985 (Washington, D.C.: Overseas Development Council and Transaction Books, 1985).

How can the World Bank avoid the same sort of political backlash? I think it's especially important—and I think Christine earlier in the day really addressed that issue by arguing that the World Bank has to rethink its structural adjustment lending, particularly because the World Bank doesn't have the leverage the IMF has, precisely because the countries are not in quite as desperate shape so the countries are able to say no to structural adjustment, as Brazil in fact did not long ago. I think that's the basis behind the point of what I'm saying, that structural adjustment has to be made more flexible, etc.

So I would argue basically that a key issue now really is how to make those structural adjustment lendings, how to do more of it and at the same time avoid the political backlash that we've seen against the IMF.

Mr. REIFMAN. Paul Krugman.

Mr. KRUGMAN. I just wanted to say I think one of the surprises of this whole thing has been the extent to which countries are able to make at least a short-run adjustment of their external accounts, of their trade accounts, to get through the crisis so far.

And it's occurred to me that we shouldn't be surprised at that. In absolute terms, the numbers are enormous, but we are really in each case talking about a net change in the external position of a few percent of GNP, a shift of inward transfer of resources of 2 percent of GNP to a few percent more outward.

Mr. REIFMAN. It's huge, though, Paul.

Mr. KRUGMAN. Well, it is in fact huge, but why is it huge? The reason it's huge is that the countries are having to shift into producing different kinds of goods from what they were producing before. The point that I would make, though, is that resource shifts of this size are something that countries do all the time. But the usual way they do it is when they fight wars.

What we're talking about, if we look at the actual burden of adjustment that we're seeing Latin Amercian countries having to do, it's equivalent to fighting modest size wars, which is in fact something countries do all the time. It's something even very weak governments manage to find resources to do.

The only peculiarity about the debt crisis is the extremely large unemployment of resources that we're seeing that goes along with the shift, and here's where I think one has to criticize the nature of IMF conditionality. Nobody tries to fight inflation while fighting a war, and in this case we have the peculiarity of combining the anti-inflation policies with the necessary resource transfer.

But if you had taken that as your perspective, you wouldn't have been surprised at the ability of these countries in the short term to make that kind of switch of resources.

The question is how long can you get people to keep financing the war when the war is being fought to the benefit of foreign creditors, and that's not really clear.

Mr. CLINE. You move one piece of money from one pocket to another and I would agree with what Jamie [Galbraith] said. You have a hell of a problem that's going to grow worse rather than better, I would think, unless the administration is going to tell us it has a brand new set of cards to play in the coming year. I've seen some things, including one story in our own newspaper, about

a new Third World initiative and I hope maybe somebody would tell us about it.

Mr. FEINBERG. It was just an argument the administration could make. Arms control with the Soviet Union implies that the Soviets will be able to move more resources into Soviet adventurism in the Third World; therefore, part of an obstacle to the Soviets has to be a sharp increase in U.S. security and economic——

Mr. REIFMAN. Well, we could——

Mr. FEINBERG. And we could finance it with a cut in defense expenditures. [Laughter.]

Mr. REIFMAN. Christine.

Ms. BINDERT. Well, listening to everybody, I'm becoming even more pessimistic because it's clear that from the point of view of each one of us, what we say makes a lot of sense; from the perspective of the bankers, what Larry [Brainard] says makes a lot of sense; from the perspective of the IMF, as some commentators have implied, what they do makes sense. But the problem is when all of the different pieces of the puzzle are put together, it's a real mess, and we really don't know how we're going to get out of the current debt problem. It's very clear that there is no coordinator of the different pieces of the puzzle in the cases of the small debtors.

The U.S. Government, for a variety of reasons, either is not willing or is unable to play a more active role and it's not clear to me that the IMF is going to be able to continue playing the limited role that it has played so far. To the extent that more and more countries are going to try to avoid the IMF, countries such as Venezuela, Mexico, Yugoslavia and many others that are trying to get rid of the IMF, is the IMF really going to be left only with so-called basket cases? In that case, who is going to play the role of trying to make the puzzle fit? I don't have the solution.

Mr. REIFMAN. Are there any volunteers around here?

Mr. HALLBERG. I don't have a solution either, but what struck me about Mr. Brainard's comments is this feeling of extreme caution and risk aversion of banks that apparently is the feeling now compared with the claim in some popular and academic literature that banks overlent during the 1970s and took on particularly in the beginning of the 1970s, more risky investments in order to try to maintain their incomes in the face of easy monetary policy in the U.S. or some claims that there was overlending going on before the second oil crisis even in a fairly unstable international financial conditions in the wake of the first oil shock. And I'm surprised at that extreme change from a loan-promoting view to one of extreme caution.

Maybe that's just a stereotype——

Mr. BRAINARD. We're trying to save our necks. That's all.

Ms. HALLSBERG. The final comment is that your claim that this is partly due to an unstable international financial system, it's perhaps true that one reason that the international financial system is unstable is that there have been such abrupt changes in the flows of lending to the developing countries from the private banking system that the reaction of instability may be causing more instability.

Mr. BRAINARD. The role of the banks has essentially been to amplify the economic cycles and the instabilities in the system. In

other words, you have overlending in periods of boom and underlending in periods of retraction. It's the same type of phenomena that is related to the generation of business cycles found in other economic literature.

Mr. REIFMAN. Mr. de Lattre.

Mr. DE LATTRE. As you requested some injection of optimism, let me say a few words, with first an apology for not having been able to attend the whole day.

It seems to me that there are a few problems that the banks would need to address in the future. They have been outlined by Larry. They refer to the question of "fair treatment," (comparable amounts of resources from the banks and from the governments), and also to the question of "flexibility," which maybe one could look at with a little less pessimism.

Let me address first the issue of comparable efforts by the governments and the banks. It's a very difficult issue because if we are talking about Latin America, there is no concessional assistance. Indeed it's very sad that the result of the IDA negotiation has been so unsatisfactory. It is very sad and maybe you could say it's a shame. But it has very little to do with Latin America. It has to do with countries which are not indebted to the banking system. The question in Latin America is more to do with the World Bank conventional resources. It is the question of how the structural adjustment loans could be increased. There is the problem of finding new projects for which funds would be disbursed fast enough. The bank is moving in that direction, but today the World Bank is not bringing an enormous amount of money to Latin America, with the exception of Brazil. And if you make the slightly dishonest calculation, which is frequent and rather to include interest payments in the total transfers you find a number of countries in Latin America where the Bank is actually taking money out. I'm not endorsing this presentation but it's just to say that the volume of concessional resources from the governments is not maybe the most urgent remedy to Latin America's problems.

Let's move to bilateral aid. This is a sort of theological discussion. We've been trying to clarify it. Who does more? The governments say we do more, we have been rescheduling 85 percent of the interest in certain cases where the banks are providing new money to be paid for interest. So even if the scheduling of the principal are equal, we do more. The banks are not sure that is true but that's something that has to be checked case by case to make sure of the actual value of each party's condition.

But what is much more important is a discussion about the future. Are the governments really opening the doors of credit insurance, when the banks are lending fresh money which is actually used. An example is the case of Brazil, in which the $1.5 billion of the Ex-Im Bank is practically unused. Why, and is there a chance that this would change? It seems unlikely. First, in the case of the $1.5 billion from the Ex-Im Bank, this low rate of utilization can be linked to the high dollar, and also to the difficulties of the procedure which means that the banks sometime do not like to get into the guaranteed money. But even aside from that, most of this government guaranteed money is not fungible. It is linked to export in a given country which does not necessarily correspond to the most

urgent needs of the country. It is linked part of it to medium-term projects which will not materialize or are not in the highest position of priority of the country.

So one should encourage the governments to do more; but the means through which they can do more are not that many and we have got to be realistic about that.

Does it derive from that that there will be no money available? I am maybe a little less pessimistic than Larry. It's true that, in the case of the difficult countries—that is, those who have not benefitted very much from the high U.S. trade deficit or those who lived too much on commodity prices—Chile and some others, more involuntary lending will be difficult. One might also mention Argentina although to my mind is a quite different case. Here the banks are reluctant to give the $5.5 billion, not because it's a poor country but because they are not convinced that the adjustment is really being made.

But when the country is performing and improving, one sees that the banks do resume their lending. This is the case of Mexico where there's a large amount of trade financing. This is the case for Brazil. We are even told that sometimes there is the beginning of competition for this lending. Think also of the extremely large amount of bank lending that takes place in the rest of the world, to the Asian countries, to Australia whose indebtedness has gone up from $4 billion to $40 billion in four years.

There is a willingness of the banks to lend as soon as the situation improves.

One other area which has to be explored is of course the capital market. This capital market has supplied very little to the LDCs during the last ten years, some $23 billion as against nearly $600 billion of bank loans. But if this is no solution for the LDCs as a whole, it may be an important ingredient for the most advanced countries. Mexico, Brazil may tap next year capital markets and in a rather successful way. Think also of all the amount of money that is the flight of capital. If there is any way of reintroducing some sort of confidence, this money can switch very fast. There is also the question of floating rate notes which somehow bypasses the distinction between individual or institutional lenders and banks and replaces it by a distinction between classical bank loans and bonds, some of which might now be held by banks.

Another subject which I think would normally find a solution is the monitoring of the country's efforts. Larry [Brainard] says the banks have no control on that. That's true. They are not able to dictate conditions themselves, but they have not lost the grip. In the case of Mexico, the Mexicans have said they have difficulties in maintaining the IMF control after the end of the stand by arrangements, but the banks have insisted, and successfully, to bring the IMF in, and at least for the next two years the IMF is going to monitor Mexico every six months.

The banks themselves will evolve mechanisms to in effect know what's going on. The economic teams of the advisory groups have done very well for the few countries in which they have been active, the major ones. For its part, the Institute of International Finance is also working in this direction.

After a time, the banks will have a much improved relationship with the IMF, the World Bank, and making a judgment on what a country is really doing.

In the area of available resources there is also the issue of flexibility of adjustment; that is, who will reschedule in the future if there is rescheduling. On the whole, it seems to me that the banks are linked to the international organizations in a more "systemic" way than they were in the past and that they will give the money which is needed once they are satisfied that all other sources have done their maximum, that the countries have lowered their current account deficit to the minimum, that foreign direct investment is encouraged both by the host country and by themselves, that the bond markets have been tapped to the appropriate level, that everything is done for flight of capital, and that finally they will have to lend less than in the late '70s or '80–81 but more than in '83.

Mr. REIFMAN. Thank you. I'm reminded of the saying that governments always follow the best policy, after they have tried all the others. Thank you, Andre, for the words of encouragement and other options we need.

We're running much later than I had planned. I'd like to propose a five-minute break and then we'll come back and listen to what the U.S. Government, that is the Executive Branch, has to say and try to end it before 4:30 if possible.

[A brief recess was taken.]

Mr. REIFMAN. Mr. DeFalco will be giving us the Treasury or perhaps the Executive Branch point of view. He's the Director of Developing Nations Finances. Do I have that right?

Mr. DEFALCO. That's right.

Mr. REIFMAN. Ciro.

THE U.S. GOVERNMENT'S VIEW—BY CIRO DeFALCO, U.S. TREASURY

Mr. DEFALCO. Thank you very much. First of all, let me apologize for Mr. Mulford who was on your agenda today. He's out of the country. He had designated his Deputy Assistant Secretary, Mr. Conrow, who is today Acting Assistant Secretary. He discovered at the last minute that he had something else to do which was very urgent and sort of at the last minute I have been asked to fill in. So I apologize that you will have to be satisfied with not only the second best but the third best.

I am also sorry that I was not here to listen to some of the speakers earlier on, but as I have sat here for the last hour or so I have been hearing quite a bit about pessimism and optimism.

I think the U.S. Government is neither a pessimist nor an optimist on this issue. I think the U.S. Government takes a very realistic view of the issue of the debt problems of the developing countries. The reason is very simple. There are no quick fixes, to coin a new term.

As Mr. Brainard pointed out, there are very limited options and some of those options are really not viable. I'm referring particularly to his second option which was more government assistance including government guarantees; in effect, the government taking

over this debt. As my colleague here pointed out, there is no way you're going to get the U.S. Congress, or by the same token, the parliaments of the other governments to take over that debt.

So what is needed is really realism and that means patience. It requires a lot of patience. We're going to have to live with this problem for a few years still. We have lived with it for two and half or almost three years. We are going to have to live with it for several more years before we can really say we're out of the woods.

Significant progress has been made since the crisis of mid-1982 when Mexico started this whole process. The situation has since dramatically improved. The major developing countries have by and large either undertaken major adjustment programs with the support the IMF or are in the process of reaching agreements to stabilize their balance of payments and economic situation.

Really, of all the major debtor countries, the only one that still have not reached an agreement with the IMF is really Nigeria. Nigeria is still not there. It hasn't started negotiating seriously. Argentina is now in the process of getting a Fund program through the board. It has signed a letter of intent and it is now trying to work out an agreement with the banks which will permit the managing director to send the program forward to the board.

So if you look at the situation today and where we were a few years ago, I would say considerable progress has been made.

The uncertainty and the anxiety of 1982 have therefore been replaced by, I would say, cautious optimism, although I don't like to use the word optimism; certainly the anxiety and the uncertainty of '82 has been replaced with at least some renewed hope for growth and a gradual normalization of the relationship between the debtor countries and the creditors, both the banks and the official creditors.

Now this contrast between two years ago and today has not really been the result of a simple chance of good fortune. It has been the result of a carefully planned strategy that has been pursued with diligence and hard work by both creditors and debtors alike. It's not just our strategy. It's a debt strategy that's been reaffirmed at the last two summit meetings of the industrialized countries.

The key aspect of the strategy is the need for debtor countries to adjust. The adjustment on the part of the debtors has been a crucial and indispensable element in the improvement that we've seen in the last few years.

Now why is this such a critical element? It is such a critical element because the debt crisis just did not happen in 1982 or was not just the result of the increase in the oil price shock in '79-80 or the rise in the dollar exchange rate. The cause of the debt crisis had its domestic origins in the economic policies—of the debtor countries and so what we are seeing and what we will continue to see is a change in these policies—budget deficits, excessive government spending, government interference in the markets, price controls and so on. And the IMF is making considerable amount of progress in helping these countries adopt more market-oriented policies.

We can argue whether the Fund is being too harsh or too soft. The fact of the matter is that the Fund has made considerable progress in helping these countries adjust in the last two years.

The United States has made a contribution to this improvement and that contribution has been in the form of a sustained economic recovery that has been the longest I think since the end of the Second World War.

This growth has provided not only jobs for the U.S. work force but has, more importantly for the issue at hand, increased imports from debtor countries and they have provided an opportunity for the export-led recovery of many of the developing countries.

For example, U.S. imports in the first half of the year, the latest data I could get my hands on, were up on the order of 32 to 35 percent and for the year as a whole we may see imports up by 25 percent over last year. Imports from the non-OPEC developing countries have gone up by more than $12 billion in the first seven months of this year. We are now seeing interest rates going down and we have roughly calculated that for every one percent decline in interest rates the savings in interest payments for the seven largest debtor countries are over $2 billion. That's for every one percent drop in interest rates.

What am I saying in effect? I guess I'm repeating what probably Bill Cline said this morning. If the developed world continues to see a sustained economic recovery for the next three or four years, if we see—and these are all big "ifs", but you have to make some assumptions—if interest rates come down in the next couple years, if we continue to keep our markets open to the exports of these countries, then I think two years fron now we will reunite in this room and see that further progress will have, been made.

We may by then not see the end of this crisis, but we will have made additional improvement which may lead us to say that there is a light at the end of this tunnel.

Mr. REIFMAN. Thank you very much. Thank you also for being brief. I know you've got enough material to go on.

Let me invite comments now on all the issues that have been raised and perhaps somebody would be brave enough to draw out some of the conclusions that we have reached. I, myself, would have trouble with that.

Jamie, did you want to comment?

Mr. GALBRAITH. Yes. Two basic comments on my Treasury colleague's statement, on one of which I would like to hear from Mr. Amaral, if he would be so kind. That has to do with the consequences of not sustaining the U.S. recovery.

As you say, this recovery has been relatively strong, by postwar standards. Actually, it's now about average for a postwar recovery. But as I read the evidence over the summer, the probability of that being sustained at anything like the rates of the last year and half are low. We could be talking next year about 2 percent growth in the United States or we could be talking about less.

And so my question for my Brazilian friend is, given that your adjustment program has been so vigorously oriented toward expanding exports into the U.S. markets, what do you think the consequences would be if the slowdown in the U.S. recovery in 1985 proved to be on the order of, say to, 2 percent or worse?

The second question: Since we established through Mr. Sjaastad's paper and also Bill Cline's statement this morning that the primary criteria for continuing manageability of the debt in the large

debtor cases was sustained recovery, then, if this does not happen, we fall back on the one remaining saving factor, which is the Sjaastad point about the consequences of a large depreciation in the dollar. And we have to ask what is the likelihood of that.

On that, I would only note that in the early version of Larry Sjaastad's paper, the September version, he quoted Martin Feldstein as his authority for a prediction that the dollar would fall by 5 percent or so in 1985. That, alas, was also the prediction for 1984.

Mr. REIFMAN. And 1983.

Mr. FRANKEL. Feldstein never predicted the dollar would decline by 5 percent. He only said that the markets expected the dollar to decline by 5 percent. That's much different.

Mr. GALBRAITH. I stand revised but not essentially corrected.

Mr. REIFMAN. Sergio.

Mr. AMARAL. I would like to answer your question but I don't know whether I have the precise figures for that. In most forecasts of the impact of the international environment on the Brazilian adjustment, one can find some common traits. One of them is an estimate of 3 percent growth in OECD countries in the next few years and an estimate of a 10 LIBOR.

If this happens and the remaining variables behave in a positive way, you may expect to have 4 to 4.5 percent growth from now to the end of the decade. This would permit the restoration of the 1980 per capita income by 1990 but unemployment levels would remain the same. This shows how precarious even what is seen as a good prospect can be. However, if this picture does not materialize—if you don't have 3 percent growth in the OECD countries and a LIBOR of 10 percent, the prospect is much more worrisome, and one has to wonder if the present adjustment is sustainable.

Mr. REIFMAN. Larry Sjaastad isn't here, so we can talk freely about what he might have said. One way he put the problem in the paper that Jamie and I read, not the new one because it just appeared, is that he says that the basic issue is whether the international financial system requires a radical change to transfer resources to the debtor countries or is it something—we have been talking about this—to be worked out only between the borrowers and the lenders without interference by governments.

We've talked about this on and off but I would like to hear anybody who has strong views on this issue.

Mr. FEINBERG. My strong views are that the dichotomy is much too severe and it's unlikely to be important to anybody because what we've had is a mixed effort with the public sector and private sector working together in many ways over the last few years, and I think to propose it as either a massive government job on the one hand or pure market switching on the other is to really miss what has been happening or what is likely to happen.

Mr. KRUGMAN. I think those are the two extremes of the dichotomy but it's not at all the choice we will be faced with. In particular, it misses a key point. The crucial factor in the crisis has surely been the distinction between what is individually in the interest of the creditors and what is collectively in their interest. We have had a situation where even from the point of view of creditors there is a public goods aspect to maintenance of lending, and that's situation where even if the bulk of resources were to come from

the private sector that by no means implies that you should leave it up to the private sector to arrange that. You need the friendly helping hand of the central banks of the governments to make sure that that happens.

Mr. REIFMAN. On the numbers, which are important—we live by numbers—Mr. Cline is very optimistic as we heard, and Enders and Mattione, both of whom were invited but couldn't make it, and the Inter-American Development Bank are pessimistic.

Mr. ESPINOSA-CARRANZA. I wouldn't say that.

Mr. REIFMAN. Pardon.

Mr. ESPINOSA-CARRANZA. I would not say that I am so pessimistic. I am not pessimistic with respect to the outlook of the Latin American economies for the years ahead during this decade. But I think the outlook depends upon certain conditions in the international environment. First, a rate of economic growth in the OECD countries of at least 2.5 percent per year. Second, international interest rates in the range of 10 to 12 percent or anything lower. Third, an expansion in international trade high enough to accommodate a rate of growth of Latin American exports equal to 11 percent yearly or more—which is similar to the outcome this year.

In the projections prepared at the Bank, we did not take into consideration any prospective change in the value of the dollar, because it may have opposing effects. On one side, a dollar depreciation may provide conditions for a gain in Latin American terms of trade and a decrease in the nominal value of the external debt. On the other side, it may have the effect to lower the Latin American exports to the United States market that has been the most dynamic one in 1983–84.

Mr. TRUMAN. I was going to take the liberty to say something in response to something that Jamie [Galbraith] raised, what I think Bill might say, since I've probably known him longer than anyone in the room.

He does have a slowdown. In fact, he has less than 3 percent for '85 and '86 in his so-called revised projections. Now I think one could argue whether it is enough or right but I think it is "optimistic" results. I think it is important to recognize there are two points to be drawn from that. One is that it is unrealistic to say here we are, draw a straight line out and assume there will be no deviation along the way. That's a reasonable way of making a scenario, but what you should do is focus on where you are at the end point rather than sort of taking everything that you've had in the past and forgetting about it and Bill makes some attempt to, in effect, say we have had a better '83–84 in terms of both performance of interest rates and performance of world economy than one should reasonably expect. So at a minimum you should expect to have to take some of that back.

So on the one hand, he doesn't go so far as to be a euphoric optimist, if I could put it that way, and I think that is an important part of the very realistic view that Ciro put forward which is that here you are two years from now and if things don't go too far off track in terms of the environment we will make further progress that will look different on a different scale, which I certainly would agree with.

One question has to do with this question of the exchange rate and I was glad to hear Mr. Espinosa-Carranza's comments because it does strike me, at least as an economist, that that is one of the more slippery concepts to deal with in this context. The exchange rate being in some sense the most endogenous of endogenous variables in the international financial system, I would argue, it is very difficult to say magically the exchange rate falls and then you have these consequences in terms of trade or demand and so forth just because you don't have the story about what else goes along with that exchange rate change.

I know there are a number of people who have labored in this vineyard that have laid out scenarios, including some of my own colleagues, which have the exchange rate change built into the process, but I think it's somewhat misleading to suggest that that is either crucial or that one can draw strong conclusions from what the consequences would be if it didn't occur, which depends at least in my sense on what goes along with it, and even then, I think it's debatable in terms of the situation of individual countries as to whether we will be better off.

One thing he didn't point out, for example, is that some of the multi-year restructuring arrangements involves a shift from that—banks insistance involves a shift in the denomination of debt which at a minimum changes the nature of those kind of calculations if there's a drop in the exchange rate. In the short run, it lowers the interest rate. In the longer run, in the sense the dollar goes down, you have the other side of the "v". I'm not too sure one wants to draw a longer run conclusion, if I can put it that way. I guess I would align myself with sort of Mr. Feinberg and Mr. Defalco in saying there's a spectrum. They may not like to be linked together but I put them together. There is a spectrum and the problem is the probability distribution over that spectrum and it tends to depend on both in terms of the global situation and in terms of the individual countries, and I would be certain it has a peak in it. It's not an even spectrum. There's now an even distribution between the princess and the tiger and everything in between.

There's a sort of something in the middle that probably is for the system as a whole is the most reasonable conclusion. I'm not sure that isn't the sense in which we have all these differing views in this seminar as a whole. That is sort of what one draws out of it. There are lots of ways, especially if you look at individual country cases or individual specific disastrous scenarios, where you could say there is a lot of room to have a catastrophe of some sort, but there's a sense in which that has relatively low probability and, as Ciro says, probably a much lower probability than people looking at this situation said or did say, both on the economic and political side, a couple years ago.

Mr. KRUGMAN. Just a quick response to that. One of the fortunate things that we have inadvertently arranged I think is that there's been a certain amount of hedging in the short-run outlook. If the U.S. economy should slow—certainly what the markets seem to think now—that would mean presumably lower interest rates and a lower dollar. If the U.S. economy should pick up steam again, that would mean higher interest rates and a higher dollar.

Mr. GALBRAITH. Well, that's mixed. The circumstances are quite different.

Mr. KRUGMAN. That's right. I'm not saying it's a perfect mix, but there's some.

Mr. FRANKEL. There's also the scenario that says that if foreigners should lose confidence in the dollar and pull out, then the dollar does down and interest rates go up.

Mr. REIFMAN. That's right. I thought you were going to say they pull their money out of the United States and invest it in Chile.

Mr. AMARAL. Let me make some general comments. When I came here I had some doubts and worries about the medium term prospects, I realize now that these doubts are shared by many of you and I don't think, unfortunately, they have been dispelled by this discussion. I would like to go back to a point raised by Christine a few minutes ago. There is the feeling that we may be moving toward a deadlock. Each party in this problem has very sound reasons for its positions.

Take the creditor governments. They have very sound reasons to resist an increase in official lending.

The banks in their turn—and we had today a very good presentation of their point of view—have also very good reasons to seek a reduction of their exposure. The IMF and the World Bank, too, have been trying their best to accomplish the task they have been assigned.

Finally, debtor countries have also very sound reasons to refuse to bear alone the costs of dealing with the debt problem.

I think we face a situation of conflicting interests and approaches and there is no indication that these interests and approaches are going to converge. Christine mentioned that perhaps we are missing a coordinator. But there have been some efforts in this direction and in my view the IMF has been playing such a role. Creditor governments and central banks have also been playing a central part in the setting up of rescue packages. What can be argued is whether a single coordinator would be able to manage a situation in which there are so many different interests at stake and so many complex subjects—domestic policies in creditor and debtor countries, trends in the financial system, all the social and political implications of adjustment programs.

If a single coordinator is not very likely to accomplish this task, what might be the solution for a situation of conflicting interests. I think that our societies have developed mechanisms to deal with such situations, and one of them is exactly the institution where we are, the U.S. Congress. If this were a domestic issue, it would have to be solved by a discussion, an articulation of interests, and a compromise in the framework of political institutions, namely the Parliament. But no such institution like a Congress exists internationally. What thus seems to be needed is a place where the different views could be confronted and a compromise solution sought.

In other words, what I mean is that we need commonly acceptable rules of the game. That does not mean that we are going to have the same kind of programs and conditions for all countries; rather, as I said before, negotiations have to be pursued on a case-by-case basis. Nevertheless, the discussion and review of the general framework for this process has to derive from a joint reflection

of all concerned parties. That is, once more, the basic message some debtor countries were trying to convey in the meetings of Cartagena and Mar del Plata.

I think that frank dialogue and the search for a compromise is a more sensible and reasonable approach than running the risk of more extreme alternatives which have been mentioned here today.

Mr. REIFMAN. Thank you.

Does anyone want to comment on that? There is more to be said on this, but that's a very good way to end, with a question. I'd like to thank all of you for coming. Eventually this will be reproduced and you will all have copies. This has been a long session and I'm glad you all came and participated. Thank you all very much.

[Whereupon, at 4:40 p.m., the conference was concluded.]

APPENDIX A

THE LATIN AMERICAN DEBT PROBLEM

Office of the Assistant Secretary, International Affairs
United States Department of the Treasury
November 13, 1984

Prepared For
The Congressional Research Service
The Library of Congress

The financial problems of Latin America and their implications for both individual countries and the international financial system are matters of continuing concern to the United States. These issues have also been the focus of continuing attention by the media, by officials of the debtor countries, and by others genuinely concerned for the stability, well-being, and future prospects of our allies in their search for stable economic growth and development. Some of these discussions, however, have not always reflected a full appreciation of the causes of the current problem nor of the implications of the multitude of "solutions" that have been offered.

It is, therefore, important to review the dimensions of the Latin American debt problem and the economic and policy factors -- both internal and external -- that brought it about and to outline the strategy the U.S. Government has been following to deal with it since the crisis days of mid-1982. This paper will focus primarily on the major debtor nations, since they most directly affect the financial system as a whole. Our concern, however, also extends to how the debt strategy is working and its impact on the smaller debtor nations undergoing particularly difficult periods of economic, social, and political adjustment.

Finally, this paper presents an outlook for Latin American countries' ability to deal with foreign debt.

1. Origins of the Debt Problem

The origins of the debt problems are well known. Broadly speaking, they are the result of delayed domestic policy adjustments to a series of adverse external developments.

First, the domestic causes:

- Instead of adjusting their economies to the oil shocks of 1973-74, and 1979-80, most Latin American countries chose to finance their expanded current account deficits through large-scale external borrowing. Through the end of the 1970s, countries continued to push for economic growth financed by foreign savings.

- While accelerated borrowing was being used to finance rapid growth, many of these nations tried to stabilize their domestic price levels through the maintenance of deliberately overvalued exchange rates.

- As overvalued exchange rates began to erode competitiveness, a number of nations turned increasingly to export subsidies, exacerbating growing problems of fiscal imbalance.

- Numerous administrative controls on prices and interest rates also prevented markets from working effectively.

- Finally, several Latin American countries persisted in emphasizing import substitution at the expense of export expansion. These nations thus found their export potential limited while other LDCs, particularly in Asia, were able to better position themselves to increase exports and meet their oil bills from current income rather than borrowing.

Second, the external causes:

- The onset of a deep global recession in the industrialized world after 1979-80 led to a halt in import growth from Latin American countries as a group and sharp declines for several individual countries.

- The recession was accompanied by record interest rates in both nominal and real terms. Countries which had borrowed money at negative real interest rates in anticipation of continued high inflation found themselves with a rapidly rising real debt service burden.

- The speculative boom in commodity prices of the mid-1970's was short-lived.

2. The Dimensions of Latin American Debt

The combined impact of these factors resulted in a rapid build up of foreign debt. By the end of 1982, the non-oil developing countries had accumlated some $600 billion of external debt, of which about $100 billion took the form of short-term credits. Of this, over $280 billion was in the Western Hemisphere including $65 billion in short-term credits. The current account deficit of the non-oil developing countries in the Western Hemisphere had reached $45.5 billion by 1981, compared with a combined deficit of only $8.6 billion in 1977. The financing of these increased deficits, together with an accumulation of official reserves, required an acceleration in the annual growth of Latin American debt to over 20% per annum for the 1977-82 period.

By the end of 1983, the countries of the Western Hemisphere had total external debts of about $350 billion, compared with less than $120 billion in 1977. This total is projected to reach $370 billion by the end of this year. Three-fourths of this amount is owed by just four nations -- Brazil, Mexico, Argentina, and Venezuela. Brazil and Mexico alone hold 52 percent. The next four major debtors -- Chile, Peru, Colombia, and Ecuador -- account for an additional 15% of the total. Latin America's portion of the total debt owed by developing countries amounts to about 45%.

The rapid accumulation of debt occurred against a backdrop of economic adjustment in the industrial countries to deal with inflation. This shift resulted in a temporary reduction in global demand and contributed to a sharp fall in commodity prices. Austerity and adjustment were accompanied by major corrections in the underlying real rates of interest -- an adjustment with significant impact on the debt service burdens of major developing nations.

Commercial bank loans have accounted for an increasing share of Latin American debt in recent years, in part to help debtors cover interest obligations. As LDC demand for foreign borrowing increased during the 1970s, commercial banks found the countries of this Hemisphere a profitable outlet for investing their funds, part of which were deposits placed with them by the oil exporting surplus countries. This was at a time of deep recession in the industrial countries, resulting in little demand for funds from traditional customers in the face of increased liquidity in financial institutions.

For the most part, these loans were made on a floating rate basis -- interest rates adjusted every 3-6 months. At the end of 1983, U.S. commercial bank loans to Latin American countries amounted to $85.7 billion compared with less than $35 billion in 1977. These loans represented 24% of the debt of these nations at the end of 1983.

3. Role of the Commercial Banks

During the 1970s, commercial banks were praised by creditor government officials and international organizations for effectively recycling the so-called petrodollars. And a good job they did, at least initially. By returning to oil importers the money paid out to OPEC, the world economy was spared an immediate crisis. In retrospect, however, these loans were made on assumptions about interest rates and economic growth which turned out to be overly optimistic. There was a breakdown in prudent portfolio management in many banks as loan officers competed to place funds. This became apparent in the early 1980s as the world economy entered a sharp recession with interest rates reversing their long-standing real negative trends.

Floating rate debt now constitutes roughly 80% of outstanding obligations in Latin America. Consequently, the debt service burden of the Latin American countries is sensitive to interest rate changes in international financial markets. Our estimates show that, in 1984, a one percentage point increase in interest rates costs the largest four Latin American debtors approximately $2 billion in added interest obligations.

Debt service ratios[1] are also sensitive to the increasing size of foreign debt. From 28.2% of exports in 1977, total debt

[1] Payments of interest on both short and long-term debt plus current amortizations of principal of long-term debt as a percent of exports of goods and services.

service jumped to 44.0% in 1983. During the same period, the interest burden alone went from 10% to 32.2% of export receipts, due largely to the larger stock of debt.

Economic growth in the U.S. has helped offset the higher interest bills. U.S. imports from the four major debtors (Argentina, Brazil, Mexico, and Venezuela) during the first 7 months of 1984 were 24% higher than the same period in 1983 -- a gain of $3.8 billion.

Although the larger countries of the Hemisphere owe the bulk of the debt and have thus attracted the most attention, the debt problem of the small countries of the region is no less disruptive to their social fabric. If one takes debt as a percentage of GDP as a measure of sacrifice required to cope with external obligations, the smaller countries are, in several cases, no better off than their larger neighbors.

As we face the debt problem of the LDCs, our primary concern has been, by necessity, the continued health of the international financial system. At the same time, we have been striving to assure that the adjustment to sustainable financial positions, supportive of renewed growth and development, be of minimum duration and as little disruptive as possible. To proceed otherwise would be damaging to both debtors and creditors.

Another issue related to U.S. commercial bank exposure in Latin American countries is their capacity to absorb, without serious damage, a potential moratorium on principal and interest payments. Some people believe that banks would suffer a severe blow. To support their arguments, these people look at the loan/capital ratio of the various banks' Latin portfolios.

While it is true that for some banks, those ratios exceed 100% for the region as a whole, we do not believe these ratios tell the full story. Banks have been setting aside reserves to meet such contingencies and these reserves are significant by now. Debtor countries realize the importance of maintaining their creditworthiness, making a unilateral moratorium an unattractive and damaging option for debtors. In the few cases where moratoria have been announced, these have been temporary expedients while negotiations with creditors continued.

4. The Crisis of the Early 1980s

The evolution of the debt crisis in the early 1980s is by now well known. By late 1981, signs of impending crisis were becoming evident. Mexico's reserves were effectively depleted by mid-1982 while Argentina's economy continued to be crippled in the wake of the war in the South Atlantic. Brazil, which had been making sporadic efforts at adjustment in 1981, faced a rapid and debilitating deterioration in terms of trade and collapse of newer markets for exports in Africa, the Middle East, Latin America, and Eastern Europe. Brazil was forced to increase its dependence on short-term finance, particularly in the interbank market.

Mexico found itself unable to service its foreign debt by mid-1982; an emergency financial package had to be put together by the United States in cooperation with other major creditors to provide essential liquidity and time for Mexico to implement a satisfactory economic adjustment program with the support of the International Monetary Fund.

Creditors became increasingly anxious and the interbank market for Brazil began to collapse by August 1982. Interbank funding volumes contracted from over $10 billion at the end of June to around $5.5 billion 5 months later. The United States undertook a major short-term financial rescue effort for that country, providing more than $1.2 billion in short-term finance in a period of less than three months.

In response to these developments, the United States formulated a strategy of its own to deal with a problem that had become the worst threat to the international financial system in fifty years.

5. The International Debt Strategy

-- No Comprehensive Solution Possible

Despite criticism to the contrary, the Administration's approach to the international debt problem is neither ad hoc nor purely reactive. While we do indeed have a debt strategy, it is not a comprehensive solution to the debt problem in the sense of a simple formula or a global institutional response that could be applied to the variety of countries which presently constitute as a group the international debt problem.

It often seems to be forgotten that the circumstances of the more than 100 countries lumped under the heading "the developing world" are very different with respect to their stages of development, their adaption to global economic trends and their respective relationships to the international private and public credit system. Some of these countries do indeed have acute problems and the potential inability to service their international debt could, under certain circumstances, damage the world credit and payment system.

The great diversity of countries and financial situations demands a case-by-case approach to debt problems. Debtors vary by need, capacity for adjustment, and potential for sustainable long-term growth. Creditors operate from many different countries under varying constraints, with differing missions, obligations, and limits to their ability to adapt to debtor problems and demands. Political situations are uniform only in their diversity while international markets for finance and trade are equally complex and not subject to easy regulations or controls. These realities are the true obstacles to a comprehensive solution to the debt problem.

Our debt strategy is not based on a formula but on the

implementation of a set of conditions, which, if fulfilled over the medium term, can lead to a basic improvement in the creditworthiness of many of the heavily indebted countries. Success would be defined by those countries developing an improved capacity to service their debt while maintaining imports at levels sufficient to support sound economic growth.

Debtor countries need not and should not have to pay down their debt to a zero base for the world to be free from the so-called debt crisis. It is normal for developing countries to be net importers of savings from abroad and to utilize debt for the advancement of their economies. It is a question of the capacity of their economies to carry debt, which means that our long term aim must be the restoration of economic conditions which improve their capacity to carry debt comfortably.

Our approach assumes that the adjustments accomplished by both the industrial and developing countries will now set the stage for an enduring expansion of world economic activity. It assumes further that most countries will follow sensible policies of curbing inflation and keeping their economies open to international competition. It is realistic enough to allow for countries some special assistance from international organizations and other governments. Finally, it is pragmatic in its assumption that the resolution of problems must be worked out, country by country.

The strategy was first enunciated in the fall of 1982 in the wake of the Mexican debt crisis. It was endorsed by the seven heads of State at the Williamsburg Summit in 1983, and has wide support throughout the international financial community. It was reaffirmed at the London Summit in June, 1984.

-- Five Point Strategy

In its original formulation, our international debt strategy consisted of five elements: (1) economic adjustment by the debtor countries; (2) economic recovery, sustained growth and open markets in the industrialized countries; (3) adequate resources for the International Monetary Fund (IMF); (4) continued commercial bank lending for countries making determined adjustment efforts; and (5) readiness to provide bridge financing, as necessary, from central banks and governments, on a case-by-case basis, in support of adjustment efforts.

Let me elaborate on each element in the strategy:

The first, and indeed central, element of the strategy is that debtor countries in financial difficulty adopt comprehensive, credible and effective programs for strengthening their balance of payments and stabilizing their economies. Generally, these are policies that reduce internal imbalances commonly associated with excessive government spending and those controls that encourage savings and investment and that make domestic production more competitive on international markets through realistic exchange rates. A number of nations have successfully implemented sound programs, laying the basis for restoration of stable economic growth.

The second element is that the industrial countries follow policies leading to sustainable, non-inflationary economic growth. At the same time, they must keep their markets open to exports from developing countries. Multilateral efforts are underway, with U.S. support, to roll back protectionist measures where possible, and to maintain our basic commitment to open markets. Growth is essential if the developing countries are going to increase their foreign exchange earnings. No other measure can have as powerful an effect as substantial non-inflationary growth in the industrial world.

The third element in our strategy has been a strengthening of the IMF. The resources for the Fund have been increased to assure that it has adequate funds to play its central role in helping debtor countries formulate adjustment programs that will deal with economic problems and encourage creditors to provide more financial support. These new resources consist of the increase in quotas, the enlargement and modification of the general arrangements to borrow (GAB), and recently concluded borrowing arrangements.

The fourth element is continued commercial bank lending for countries making determined adjustment efforts. Commercial banks generally have shown a willingness not only to continue lending to these countries, but to do so on better terms in cases where the debtor is making clear progress in its adjustment program.

The fifth element concerns the readiness of creditor governments to provide bridge financing on a selective basis when appropriate. This financing generally fills the gap between the time when a program has been worked out with the IMF but before its resources and those of the commercial banks are disbursed.

At the London Summit in early June, 1984, the seven summit countries reviewed the debt situation in the mixed circumstances of a much more favorable outlook for world growth and new anxieties arising from the recent increase of interest rates. The U.S. economy is now in its eighth quarter of expansion. OECD growth, which was 2.2% in 1983 compared to -0.1% in 1982, is projected to be almost 5% in 1984. The volume of developing country exports is rising and their terms of trade are improving. The rising U.S. trade deficit reflects this situation We are far from being out of the woods but successes are becoming more frequent.

At the London Summit we considered what might be done, within the framework of our agreed debt strategy, to assist the process. The Summit Communique on this issue can be summarized as follows:

a) the role of the international organizations: reaffirming the central role of the IMF, its cooperative relation with the World Bank and strenghtening of the latter's function in the area of medium- and long-term development;

b) encouragement of private banks to make more extended multi-year rescheduling of their credits and the willingness of governments to do the same where their credits are concerned to countries who are adjusting well; and

c) emphasis on the potential importance of direct investment.

To further the international dialogue on managing external indebtedness over the medium- and long-term, during the September 1984 annual meetings of the IMF and World Bank, the U.S. Government proposed that at their spring 1985 meetings, the Development and Interim Committees discuss the following debt-related issues: economic growth and attendant financing in developing countries, the relative role of and realistic prospects for Official Development Assistance (ODA), commercial bank and direct investment flows, prospects for restoration of developing country creditworthiness, and trade policies and protectionism.

6. Role of Evolution and Pragmatism

It is understandable that the air is full of proposals "to do something" about the debt crisis. Proposals are generally comprehensive in scope and include sweeping transfers of private credits to creditor governments, substantial relaxation of IMF-supported adjustment programs, doubling of official credits, plus major increases for the MDBs and bilateral programs. They also include unilateral trade concessions by the U.S. and other industralized countries, such as a considerable expansion of the coverage of our Generalized Schedule of Preferences, and proposals designed to shore up one element or the other of the international private credit system. Too often they assume that the present system is breaking down. They usually take individual debtor country adjustment for granted or even assume that the adjustment process is not tenable, and therefore should be dropped.

These proposals fail also to take into account the profound differences among developing countries. These countries are at different stages of development and at different points on the cycle of adjustment. There are those who have made sacrifices and are succeeding, those who have made sacrifices and have yet to see significant results and those who are unable or unwilling thus far to make a beginning. All stand in different political relationships to major creditor governments and to each other. The development strategy they chose in the past make some better able to withstand adversity than others.

Finally, some proposals are politically unrealistic in that they assume a public intrusion into the market place as well as a commitment of budgetary resources that neither the Executive Branch nor the Congress believe is desirable.

These proposals also fail to take into account differences in the development environment and disregard the complexity of our financial system. The United States Government's debt strategy

ties together the admittedly complex strands of this problem, evolving as circumstances change. We cannot predict the course of that evolution, but it should be a pragmatic one, rooted in particular solutions for particular countries, and not at this time in an across-the-board formula agreed and imposed by governments or international organizations.

What needs to be understood is that resolving this problem will take time, patience, and more time. All the players -- debtor country governments, commercial banks, creditor governments, and international institutions continue to need time to assess their experience and to understand their roles -- to assess more carefully their tolerance for pain or their ability to innovate. Only by experience can the participants establish their most pressing priorities, what is essential and what can be altered or discarded when the chips are down. Only by a series of difficult negotiations, conducted patiently and with restraint, over a long period of time, will the principal actors deepen their understanding of the dimensions of their problems and the nature of solutions that may realistically be applied.

7. Managing the Debt Problem -- Progress to Date

Economic adjustment in Latin America began in earnest during 1982 and accelerated in 1983. This acceleration was apparent in both the negative domestic impact and the positive results achieved in the region's external accounts. From a combined trade deficit of $10.7 billion in 1981, the non-oil developing nations in Latin America achieved a surplus of $19.2 billion in 1983. This massive turnaround was achieved despite the relatively modest recovery in non-oil primary commodity prices for the region (about 5% in 1983) following declines of 24% after 1979. In just two years, imports were cut by nearly 40% and intra-regional trade contracted sharply.

The current account deficits in the region were cut nearly in half in 1983 and the rate of growth in external indebtedness slowed to around 4%, compared with an average annual growth of 21% during the previous five years.

These improvements in key indicators for the non-oil Latin countries offer evidence of the pace of adjustment that has taken place since mid-1982. The real story, however, is that of individual nations making major efforts to come to grips with their problems with the support of private and public creditors and, the multilateral development banks, and the International Monetary Fund (IMF).

Since 1981, sixteen of the twenty eight countries in Latin America have entered into agreements with the IMF. Some critics would argue that the IMF programs have been responsible for the recent decline in economic activity experienced within the region. But, the drop in economic activity was caused by the recession aggravated by prolonged economic mismanagement and excessive reliance on external borrowing.

The purpose of IMF programs is to achieve a more efficient allocation of resources and a sustainable balance of payments position in the medium term through a process of orderly adjustment. These policies are designed to lay the basis for more vigorous and lasting growth and development and to minimize the pain and suffering entailed in the process of adjustment.

In the absence of IMF programs, adjustment would eventually occur in some form, but at a far more disruptive and disorderly pace that would exacerbate human suffering and needlessly delay renewed growth.

8. A Look at Individual Countries

It is helpful to review the progress made over the last two years by countries most affected by the need to adjust their external accounts.

Mexico was, in many ways, the first country to reach a crisis point after its non-oil export earnings declined in real terms in 1980 and 1981 while its continued massive increases in investment outlays and imports resulted in unprecedented and unsustainable deficits in the balance of payments. The deficit in the current account almost doubled -- from $7.7 billion in 1980 to $14 billion in 1981. Growing loss of confidence in the face of Mexico's exchange rate rigidity and higher interest rates in the United States resulted in accelerating capital flight that culminated in an inability to obtain new external financing or rollover of maturing obligations by August 1982.

Mexico adjusted to this situation with an abrupt deceleration of growth and a severe contraction of imports. Real devaluation of the peso was 32% in 1982 and another 13% in 1983. Output (real GDP) declined by 0.5% in 1982 and by 4.7% in 1983 and imports were slashed by 40% in 1982 and by 45% in 1983, leaving them at one-third the 1981 level. The government's austerity program is expected to continue through 1985 as cuts in the fiscal deficit, slowed monetary growth and a competitive exchange rate all work to nurture sound economic recovery with positive real growth.

Mexico's adjustment has been accompanied by extensive support from both private and official creditors and, as the success has become more apparent, terms from private creditors have improved. Amortization payments through the end of 1984 were rescheduled over eight years with four years grace and banks committed $5 billion in new money in 1983 and another $3.8 billion in 1984 at spreads reduced by a full percentage point.

In another show of confidence in Mexico's adjustment efforts, Mexico and its Bank Advisory Committee have agreed to a multiyear resheduling, which will further improve the terms and structure of its external debt. 2/ Under this precedent-setting agreement, about $45 billion in debt maturing 1985-90 will be rescheduled over 14 years at an average spread of 1.125 percent over LIBOR. This represents a major step toward Mexico's return to normal relations with the international financial community. The terms and conditions of this agreement may well serve in the future as the basis for other multiyear reschedulings between commercial bank creditors and countries which have made successful adjustment efforts.

Brazil's external accounts had begun to deteriorate in the late 1970s, even before the second oil crisis, due primarily to continued robust import growth to fuel major development projects. The current account deficit had already risen from $7 billion in 1978 to $12.8 billion in 1980 with financing arranged primarily through private markets. On the domestic front, disruptive credit policies were accompanied by disappointingly little progress in controlling state enterprise spending. Exports and agriculture had become extremely dependent on credit subsidies and large subsidies continued to be incurred for imported petroleum and wheat. The distortions of Brazil's indexation system began to accelerate with rising inflation, resulting in a cumulatively negative impact on public sector spending patterns.

With the deterioration of the external environment in 1982, Brazil was caught with too little adjustment too late and its current account deficit ballooned to an unfinanceable $14.7 billion. Brazil, nonetheless, moved quickly at the end of 1982 to develop a sound economic adjustment program which could inspire confidence and support from the IMF, banks, and official creditors. Although Brazil still suffers froms serious inflationary problems it has successfully undertaken the first steps in major adjustment. It should be noted that Brazilian adjustment efforts were severely hampered by the fact that twenty years of import substitutions policies and restrictions on non-essential imports left little room for cuts in imports without immediate and dramatic adverse impacts on real output.

The major achievements of the massive adjustment in Brazil's domestic economy in 1983 were reduction in the current account deficit from $14.9 billion in 1982 to $6.2 billion a year later and a sharp cut in the rate of increase in external borrowing. While the arrangment worked out for Brazil with the IMF did not evolve according to plan in 1983, Brazil has managed to stay in compliance with its revised program in 1984.

2/ At the time this report was submitted, formal agreement by all of Mexico's bank creditors was still in process.

There are signs that four years of economic stagnation and contraction may have now stabilized, with improved prospects for renewed growth in real GDP for the last half of 1984 and into 1985. Despite this dramatic progress, Brazil is still trying to cope with inflation rates on the order of 230% and fiscal management complicated by extensive indexation of the economy.

Venezuela is a relatively unique case. It is a major oil exporter which faced a huge bulge in debt service at the same time that oil prices were dropping. Venezuela's external obligations grew from $16.5 billion at end-1978 to nearly $40 billion by end-1983. More than half of the debt fell due in 1983-84.

While a restructuring of the debt was unavoidable, however, Venezuela did not need new financing in the near term, and consequently chose not to negotiate a standby credit facility with the IMF. Instead the government implemented its own adjustment program to cope with the changing international economic environement. The program achieved significant improvement in the fiscal and external balances, improvements which were recognized by the IMF.

In September 1984, Venezuela reached agreement in principal to reschedule $21 billion in public sector debt to commercial banks due through 1988. Implementation of the agreement will greatly improve Venezuela's debt service picture and preclude further liquidity problems for at least the remainder of the decade. Finalization of the agreement awaits progress towards eliminating private sector arrears, now totalling over $1 billion, which have accumulated as a result of complex regulations governing access to a preferential exchange rate.

Argentina's current economic and financial crisis is, in many respects, more the result of domestic policy and problems than external shocks. Maintenance of an overvalued exchange rate and uncontrolled increases in the public sector deficit led to a sharp deterioration in the external accounts and a unsustainable increase in external borrowing, much of it short-term. Confidence in Argentine economic policy eroded rapidly beginning in 1980 as trade performance weakened, private investment, output and unemployment declined, and inflation accelerated. Access to private foreign capital eroded as capital flight picked up in the face of excessive over-valuation of the peso. Despite repeated devaluations and sporadic efforts at stabilization, public confidence collapsed and economic performance continued to erode. This situation culminated in a generalized crisis in the wake of the war in the South Atlantic, which completed the shut-off of Argentine access to external finance.

In the aftermath of the war, Argentine economic policy was essentially moribound from mid-1982 through the end of 1983. As a result, the spontaneous adjustment of the real economy caused real GDP to fall by about 6% in 1981 and again in 1982. Real devaluations of 40% in 1980 were followed by a real appreciation

of 8% in 1983. The current account deficit was reduced from $4.7 billion in 1981 to $2.1 billion in 1983.

Although Argentina's adjustment has improved its balance of payments position, its domestic economy continues to suffer from excessive rates of inflation and a large public sector deficit. (The preliminary agreement, however, which Argentina reached with the IMF on September 25 improves prospects for adoption of a viable economic adjustment program. Implementation of the agreement hinges upon approval of the program's financing package by Argentina's commercial and official creditors.)

Chile had to wrestle with the problem of higher oil bills and the collapse of copper prices while servicing debt rapidly accumulated during the 1978-81 period. From 42% of GDP in 1979, total debt reached 71% of GDP in 1982 and an unprecedented 90% in 1983. A major factor responsible for this increase was the progressive appreciation of the peso from 1979 through mid-1982. Private external debt increased consumption and encouraged capital flight. By contrast, public external debt rose by less than $800 million during this period.

Chilean adjustment to the rapid deterioration in its external position included compression of imports, increased borrowing and a real devaluation of 36% during 1982-83. Wage indexation beginning in June 1982 contributed to large declines in real incomes. The relative magnitude of adjustment in Chile was greater in 1982/83 than in almost any other developing country. Weak copper prices have compounded Chile's burden. Despite these difficulties, Chile continues to make every effort to adhere to its economic adjustment program with the support of the IMF. The 23% devaluation of the peso in mid-September 1984 further attests to the determination of Chile to maintain compliance with its adjustment program.

Peru suffered the consequences of severe external shocks relating to commodity prices at a time of inadequate domestic adjustment, expansionary fiscal policies, heavy borrowing and breaking a three-year stagnation and decline. This is due in crisis in 1977/78 -- well before the 1979 oil price hike and the 1982 debt crisis. While recovery from the 1978 crisis was rapid and was aided by support from both the IMF and IBRD, Peru's external accounts began to erode again by 1981. Weak copper prices triggered a 15% deterioration in the country's terms of trade in 1981 and a further deterioration of nearly 14% in 1982. Lagging demand management pushed the current account deficit to $1.7 billion in 1981, 8.7% of GDP.

By 1982 the crisis had deepened with growth lagging despite expansionary fiscal and monetary policies. New borrowing was weighted toward short-term credits. Commercial banks became extremely reluctant to renew credits in 1983 and a formal rescheduling of payments was undertaken. Peru also rescheduled

official debt with a Paris Club arrangement. Appropriate exchange rate policy proved elusive, however, and adverse climatic developments helped make Peru's IMF program unattainable. A new standby arrangement was negotiated in 1984 but Peru was unable to bring the fiscal deficit under control and fell out of compliance. Efforts to address the situation have been complicated by the imminence of Presidential elections scheduled for April.

9. The Outlook

The process of adjustment to the 1982 debt crisis is not completed and considerable sacrifice by individual nations is still needed. However, with a strong growth recovery in the industrial nations and with continued creditor support, many debtor countries in the region should be able to resume economic growth. We expect both Brazil and Mexico to register positive real economic growth in 1984. Argentina, which is just now coping with problems of long-delayed adjustments, is also expected to register positive real growth this year. We anticipate that both Mexico and Brazil will see growth accelerate modesty in 1985.

We expect modest growth for the region as whole in 1984, breaking a three-year stagnation and decline. This is due in large part to increased growth and import demand in the OECD, led by the U.S. recovery. Significant per capita GDP gains are anticipated for 1985, assuming sustained recovery in industrialized nations. This growth is expected to be widespread, benefitting the smaller as well as the larger debtors. Sustainable real growth of 4-5% may be possible by 1986 for some of the countries.

The crucial development in 1985 will be the strengthening of external positions and creditworthiness of major debtors that have undertaken successful adjustment programs. Although the primary source of external finance will continue for some time to be involuntary in the sense that it will be negotiated in concert, rather than on the historically more spontaneous pattern, it should become increasingly manageable as the rate of growth of indebtedness stabilizes and the capacity for debt service improves.

Although a bunching of maturities during the 1987-88 period suggests the possibility of continued liquidity difficulties and reschedulings through the late 1980's, sustained industrial recovery and improvement in the external performance of key developing countries is expected to keep these problems from becoming anywhere near as serious as those experienced in 1982/83.

As countries strive to cope with their debt burdens, a crucial element will be their willingness to reexamine policies toward direct foreign investment. Such investments provide not only needed capital and technology, but also stabilize capital

flows and improve the management of external debt. While bank financing availability is expected to "normalize" in the near term, the major debtors should become less dependent on this form of capital financing.

The adjustment process we have described is essentially a growth-based. It is driven by the ongoing recovery of trade and improvement in the region's terms of trade. Rapid and sustained OECD recovery is critical to the process and access to industrial country markets must be maintained in the face of increasing protectionist pressures. Protectionist pressures are particularly troublesome in view of the continued close monitoring of imports that the developing countries will need to follow over the next several years.

While precise estimates or forecasts of debt service ratios are notoriously unreliable, we generally share the conclusions of the IMF that, after peaking in 1983, debt service burdens should ease in 1984-86. Improvement is likely to be frustratingly slow in some cases, but there are indications of progress in most of the larger debtors. While some smaller countries face major problems, these can be contained and ultimately resolved through domestic economic adjustment and external support.

oooooooooooooooooooooooooooo

APPENDIX B

EXTERNAL DEBT AND DEBT SERVICE: SOME COUNTRY DIFFERENCES*

by

Larry A. Sjaastad

University of Chicago and

Graduate Institute of International Studies

INTRODUCTION

This paper attempts to delineate the main causes of the current external debt crisis in the developing countries, and reasons why that crisis is striking some countries with more severity than others. The first section that follows deals with some of the important causes of the crisis itself and in particular the manner in which the current world monetary system has contributed to the problem. The next section deals with the determinants and behavior of the external debt service and leads to some immediate conclusions with respect to those country characteristics that intensify the burden of debt service. The following section examines some of the country differences, and in particular, compares the situation of the Republic of Korea with some of the major debtor countries in Latin America. The conclusion of that section is that the Korean debt problem is, for a variety of reasons, more manageable than those of most Latin American debtor countries. A short concluding section completes the paper.

---

*Prepared for the meeting on "Dealing with the Debt Problem in Latin America," sponsored by the Congressional Research Service of the Library of Congress, Washington, D.C., November 13, 1984

SOURCES OF THE DEBT PROBLEM

As I have argued elsewhere, the severity of the debt service problem arises not so much from the size of the external debt as from high real interest rates.[1] According to W. Arthur Lewis, ratios of external debt to exports in even the most heavily indebted countries is lower than in 1913.[2] Consider the case of Panama, one of the most heavily indebted countries, relative to GDP, in the world. Total public-sector debt in Panama is nearly three times current exports, and interest accruals are approximately one-third of those exports.[3] However, were the rate of interest to be 4 per cent on that debt, Panama's public-sector interest bill would only slightly exceed 10 per cent of export revenues, and could be easily managed even in the absence of an increase in external debt. A similar conclusion applies to virtually all other debtor countries.

The debt service problem becomes worse once we consider real rates of interest. The dramatic increase in those real rates came about mainly because of an equally dramatic collapse in the rate of dollar inflation of tradeable-goods prices; as will become evident subsequently, increases in nominal interest rates played but a very minor role. How did this increase in real rates of interest come about?

A plausible answer lies in the behavior of the U.S. dollar vis à vis other major currencies. During the period of very low real rates of interest (1978-80), the dollar was declining sharply against virtually all other major currencies, with the result that dollar prices of many traded goods were rising rapidly, indeed, at a much higher rate than the U.S. price level. With the recovery of the U.S. dollar, a recovery that began in late 1980 reversed that tendency; indeed, deflation rather than inflation of dollar prices of tradeable goods became quite evident.[4] We now turn to an analysis

of the manner in which changes in the exchange rates between the dollar and other major currencies affect the dollar prices of tradeable goods.

Exchange Rate Fluctuations and Relative Prices

An appreciation of a major currency, say the U.S. dollar, with respect to other major currencies (represented by the German DM) clearly will cause the dollar prices of (homogeneous) traded goods to be depressed (assuming underlying demand and supply factors for that commodity to remain unchanged), and the DM price to rise. If the law of one price holds exactly, the decline in the dollar prices plus the increase in the DM price, both in percentage terms, must sum to the percentage appreciation of the dollar. For certain highly homogeneous goods (metals, certain agricultural products, etc.), there is ample casual evidence that the law of one price holds quite well, and that the phenomenon described above does indeed occur.

For a small country pegging to the dollar and engaging heavily in the international commodity trade, an appreciation (depreciation) of the dollar *vis à vis* other major currencies will immediately experience deflationary (inflationary) pressures transmitted by changes in the dollar prices of its tradeables. This is in fact what appears to have happened in the cases of Chile and Uruguay (and in the opposite direction in Europe and Japan, but presumably with less speed and intensity). This asymmetry comes about because the commodity trade--for which the law of one price holds well even in the short run--is much less important for the large, developed economies. If changes in the prices of tradeables impact more rapidly on small economies than on large ones, as appears to be the case, then an appreciation of the dollar will impose stronger deflationary pressures on countries such as Chile and Uruguay than on the U.S., and consequently real interest rates in the former countries will rise relative to those in the U.S.

The Real Rate of Interest on External Debt

In a slightly different context, I have developed a formal model that relates movements in the exchange rates between the major currencies to fluctuations of inflation rates in countries pegging to one of those currencies.[5] The relevant equation that emerges from that analysis is the following:

$$\Pi_D^t = \sum_{i}^{N-1} K_i(\dot{E}_i) + \Pi_W \quad , \qquad (1)$$

where Π_D^t is the rate of change in an index of the prices of debtor country D's imports and exports (traded goods), those prices being denominated in the Nth major currency (e.g., the U.S. dollar). The K_i's are positive fractions that depend upon country D's pattern of international trade, and E_i is the (natural logarithm of the) price of the ith major currency in terms of the Nth currency. Π_W, the world rate of inflation, is a weighted average of the rates of domestic inflation in all countries other than D, the weights being the K_i's. A "·" over a variable indicates its time rate of change; thus $\dot{E}_i$ is to be interpreted as the percentage rate of depreciation of the dollar against, say, the DM. For most debtor countries, it is probably sufficient to limit the set of major currencies to three (i.e., $N = 3$), so that E_1 becomes the (natural logarithm of the) dollar price of the DM, and E_2 refers to the dollar price of the Yen.

A depreciation of the dollar against, let us say, the DM implies that $\dot{E}_1$ is positive, which drives up dollar prices of those goods which country D trades internationally, but by only some fraction, K_1, of that depreciation. Thus whatever is Π_W, the world rate of inflation, changes in the major currency exchange rates impart an additional inflationary or deflationary force on the prices of those traded goods.

If country D happens to have a trading pattern which involves only goods whose international markets are dominated by the U.S. (i.e., the U.S. is a "price-maker" in those markets), then K_1 and K_2 will be approximately zero, as changes in the dollar-DM and the dollar-Yen exchange rates will not affect the dollar prices of those goods. On the other hand, if the U.S. is a "price-taker" for the goods that country D trades internationally, we have that K_3 is approximately zero and the sum of K_1 and K_2 is approximately unity. In that case, a depreciation (appreciation) of the dollar against both the Yen and the DM by the same percentage would increase (decrease) dollar prices of those goods by the same amount as that of the dollar depreciation (appreciation).

Given that most of the external debt is denominated in dollars, and that debt service is achieved at the expense of fewer imports or more exports than would otherwise be the case, it follows that the dollar rate of inflation of a country's traded goods prices is the relevant deflator to convert nominal interest payments into real terms. We define the real rate of interest on external debt for country D as:

$$R \equiv i_D - \Pi_D^t \qquad (2)$$

where i_D is the average rate of interest on country D's external debt.

By substituting equation (1) into (2) and rearranging, we obtain:

$$R = R_3 + K_1(\Pi_3 - \Pi_1 - \dot{E}_1) + K_2(\Pi_3 - \Pi_2 - \dot{E}_2) \quad , \qquad (3)$$

where $R_3 \equiv i_3 - \Pi_3$ is the real rate of interest on dollar-denominated assets, with i_3 assumed to be equal to i_D. That assumption clearly holds reasonably well for index and newly-incurred dollar-denominated debt. Π_3 can be taken

to be the U.S. rate of inflation, Π_2 that of Japan, and Π_1 the European inflation rate.

Equation (3) indicates that the real rate of interest on newly-incurred and indexed dollar debt is the real rate on dollar-denominated financial instruments plus a linear combination of deviations from purchasing power parity among the major currency countries. As is well known, those deviations were substantial (and negative) during the period of the weak "Carter" dollar (i.e., $\dot{E}_1 >> \Pi_3 - \Pi_1$, and $\dot{E}_2 >> \Pi_3 - \Pi_2$). Since the recovery of the dollar, which began in late 1980, those deviations have been equally large but positive--the DM price of the dollar rose more than 65 per cent from mid-1980 to November 1984, despite a cumulated U.S. inflation that is somewhat larger than that of Germany. Thus in the earlier period, a period during which much of the debt was incurred, the departures from purchasing power parity were sufficiently strong to result in negative real rates; since 1980, however, they have contributed positively, causing real rates to be extraordinarily high.

Equation (3) can be rearranged to express real interest rates on external debt in yet another manner. Beginning with a definition of the "world" real rate of interest, R_W:

$$R_W \equiv K_1 R_1 + K_2 R_2 + K_3 R_3 \quad , \tag{4}$$

we obtain an alternative expression for the real rate on external debt:

$$R = R_W + K_1(i_3 - i_1 - \dot{E}_1) + K_2(i_3 - i_2 - \dot{E}_2) \quad , \tag{5}$$

where i_j is the nominal interest rate in country j. That is, the real rate on external dollar-denominated debt is the "world" real rate of interest plus a linear combination of departures from "strong" interest rate parity.

Those departures have been enormous; since 1980, the dollar has steadily appreciated against the DM, but dollar interest rates have consistently exceeded DM interest rates!

The consequences are spelled out in Table 1, which indicates the real interest rate on Chilean external debt. The data speak for themselves. During the period of the "Carter" dollar, real interest rates were approximately zero or negative--substantially so in 1979. In 1981, those rates rose dramatically; indeed, the real rate in 1982 was a full 36 points above the level of 1979. Note that nearly all of the movements in those real rates occurred because of alternating inflationary and deflationary effects generated by changes in the major currency exchange rates (the second and third right-hand terms of equations (3) and (5)); only a small fraction of it arose from the rise in dollar interest rates. The impact of those exchange rate changes on the dollar prices of Chilean tradeables is impressive; in 1979, that set of prices rose by more than three times the rate of U.S. inflation but, in 1981 when inflation was very high in the U.S., the dollar prices of Chilean tradeables actually fell by more than 5 per cent.

What holds for Chile also holds for most Latin American debtor countries; they have moved from a period of low and negative real rates of interest to a period of extraordinarily high real rates. This effect is not unnoticed in the United States, of course; wholesale prices have actually declined in the U.S. during six of the first ten months of 1984, and recently have declined for three consecutive months--August, September, and October. The only viable explanation for these falling prices is the appreciation of the dollar against other major currencies (the explanation for that appreciation, however, is hard to come by). There can be no doubt that a sustained depreciation of the dollar would be very good news indeed for most debtor countries.

TABLE 1

EXTERNAL PRICES OF CHILEAN TRADEABLES AND INTEREST RATES[a]

Period	Annual Rate of Change of Prices[b]	U.S. $ Interest Rate[c]	U.S. $ Real Interest Rate[d]
1977	5.1	7.0	1.8
1978	6.1	6.4	0.3
1979	26.8	11.2	-12.3
1980	16.6	13.9	-2.3
1981	-5.5	15.7	22.4
1982	-8.6	13.3	24.0
1983[e]	-4.3	9.9	14.8

[a]Taken from Jose Gil-Diaz, "Del Ajuste a la Deflacion: La Politica Economica Entre 1977 y 1981 (Chile)," Mimeo, November 1983.

[b]Rate of change of a simple average of unit values of Chilean imports and exports as calculated by the United Nations Economic Commission for Latin America.

[c]Annual averages of six month LIBOR rates.

[d]Defined against the prices of Chilean tradeables.

[e]Author's calculations for 1983.

There is another source of the debt service issue, of course, and that is the abrupt suspension of lending to the debtor countries that occurred in mid-1982. Up to that point, many debtor countries were enjoying capital inflows sufficient to cover all external debt service and permit a deficit in the trade account of their balance of payments. We now turn to an analysis of that interaction of capital flows and external debt service.

THE DYNAMICS OF DEBT SERVICE

The intensity of the external debt service problem varies widely from country to country. In a number of the smaller Latin American countries--Costa Rica, Chile and Panama in particular--the magnitude of external debt relative to GDP is simply so large that, without a major decline in interest rates or a substantial write-off of the debt by the lending institutions, one seriously doubts that that debt can be serviced even under favorable rescheduling terms. In other and larger countries--Argentina, Brazil, Mexico, Venezuela and Korea--the problem is onerous but manageable even in the face of curren interest rates with sufficient economic growth.

In the former set of countries, the ratio of external debt to GDP is of the order of magnitude of 100 per cent, whereas in the latter group it runs 40 to 55 per cent. With an average interest rate on outstanding external debt of about 10 per cent in most countries (but rising with rescheduling) interest alone amounts to 10 per cent of GDP in the heavily indebted countries, but "only" 4 to 5 per cent in the others.

The amount of actual debt service, of course, depends upon a number of factors. During the 1970s and early 1980s, none of the major debtor countries had any positive debt service from a balance-of-payments point of view; new

borrowing more than paid the interest and amortization. Since 1982 availability of new funds has declined dramatically, forcing major internal adjustments on those countries.

To examine the determinants of debt service, we develop a small model in which the following notation will be used:

D = nominal external debt, in dollars,

Y = nominal gross domestic product (GDP), in dollars,

GB = gross new borrowing, in dollars,

i = ratio of interest payments to external debt,

d = D/Y (debt to GDP ratio),

δ = amortization rate,

γ = GB/D,

$g = \dot{Y}/Y$ (growth rate of GDP),

DS = $(i + \delta)D$ = debt service, in dollars, and

NDS = $(i + \delta - \gamma)D$ = net debt service (i.e., requisite trade account surplus), in dollars.

The growth of external debt, $\dot{D}$, is the surplus in the capital account of the balance of payments, and is given by:

$$\dot{D} = GB - \gamma D$$
$$= (\gamma - \delta)D \, . \qquad (6)$$

The contribution of interest payments to the deficit in the service account of the balance of payments is obviously (iD); hence the needed surplus, NDS, in the commercial (trade) account of the balance of payments is clearly:

$$NDS = iD - \dot{D}$$
$$= (i - \gamma + \delta)D.$$

As the growth of external debt relative to GDP is:

$$\dot{d} = (\gamma - \delta - g)d,$$

we obtain:

$$NDS/Y = d[i - g - (\dot{d}/d)], \tag{7}$$

as the necessary commercial account surplus as a fraction of gross domestic product.

We now consider various scenarios. First, there was the situation of the 1970s, when external debt for all non-OPEC developing countries was increasing at a rate of nearly 20 per cent per annum. Obviously, with $\dot{d}/d \simeq 0.20$, NDS was substantially negative, permitting countries to service their debt while enjoying large current account deficits. That situation is, of course, not sustainable as the ratio d will become arbitrarily large, with default ultimately a virtual certainty.

A second scenario, still favorable, is when $\dot{d} = 0$, which implies that $\gamma = \delta + g$; the debt not only is rolled over, but also net new borrowing occurs at the rate gD. In this case:

$$NDS/Y = (i - g)d \quad ,$$

which, under current circumstances with a growth rate of dollar-denominated GDP in the neighborhood of 5 per cent, would require a current account surplus of only 2 per cent of GDP for countries such as Argentina and Brazil, and about 5 per cent for Chile and Panama. In fact, however, growth rates in all major Latin American debtor countries, measured in dollars, recently have been negative or, at best, zero. Anything that will improve growth rates--either real growth or U.S. inflation--will reduce the debt service burden. It goes without saying, of course, that an increase in the U.S. rate of inflation is likely to be reflected in nominal interest rates and with a relatively short lag in i, so the

relief from that source would be short-lived in the event of inflation.

A less favorable scenario, but one close to current circumstances, is when $\gamma = \delta$; that is, the debt is rolled over, but no new net borrowing is allowed. In this case, $\dot{d}/d = -g$ and:

$$NDS/Y = id \quad .$$

For countries such as Panama and Chile, this requires a commercial account surplus of approximately 10 per cent of GDP, which is difficult to imagine on a sustained basis.

The worst scenario occurs when no gross borrowing whatsoever is permitted, which implies $\gamma = 0$, $\dot{d}/d = -(\delta + g)d$, and:

$$NDS/Y = (i + \delta)d \quad .$$

While amortization rates vary widely over time and across countries, the average on all external debt is currently about 10 per cent per year, which implies a trade account surplus of 20 per cent of GDP in countries such as Chile and Panama, and nearly 10 per cent for larger debtor countries of Latin America. Debt service on such a scale, even for a limited amount of time, would almost surely result in massive default.

COUNTRY DIFFERENCES

There are major and important differences in the intensity of the debt and debt service problem across the major debtor countries. In the first place, the degree of indebtedness, relative to GDP or exports, is quite variable. Of the countries mentioned above, Argentina and Brazil have the smallest external debt, which runs about 40 per cent of the GDPs.[6] The next set of countries--Mexico, Venezuela and Korea, have an external indebtedness

that runs 50 to 55 per cent of GDP, and finally we have Chile and Panama, where the external debt is roughly 100 per cent of GDP. These differences imply that debt service, other things equal, poses a burden for Chile and Panama that is nearly double that faced by Argentina and Brazil.

But there are other important differences, some of which are indicated by the immediately preceeding analysis. In evaluating the severity of debt service, one must take at least three fundamental factors into account:

(a) The growth rate of the economy, and hence its ability to incur further debt on a sustained basis without increasing the ratio of debt to GDP; this consideration has a profound influence on the trade and balance of payments aspects of the debt service issue.

(b) The degree to which the debt is a direct obligation of governments as opposed to private agents of the economy. This consideration has important implications for the fiscal and political aspects of debt service.

(c) The degree to which instability of exchange rates between major currencies affects the real rate of interest on external debt.

Turning first to growth rates, it is this fact which sets Korea apart from nearly all Latin American countries. The growth rate of real GDP in Korea is and has been, with the exception of 1980, notoriously high; for the 1977-84 period, that average growth rate is estimated to be nearly 7.5 per cent per annum. During the same period, the Latin American major debtor countries have had cumulative growth rates that are far lower on the average, and since 1980, real output has actually contracted in a number of those countries, whereas the Korean growth rate for the same period has averaged over 7 per cent per annum. It is clear from equation (7) that net debt service

for Korea, as a fraction of GDP, will be far lower than for Argentina and Brazil if all three countries could maintain their external indebtedness, relative to GDP, at the current level. It goes without saying that a rapidly growing country such as Korea is much more likely to be able to do just that, despite the much larger borrowing that is involved, than is a country whose economy is stagnant.

This consideration indicates that trade surplus required of a rapidly growing country is far less than that for a stagnant economy. A country with no internal growth that succeeds in rolling over all of its external debt must still generate a trade surplus sufficient to pay the interest on that debt. On the other hand, a country with a 7 to 8 per cent real growth rate, and one which also rolls over its external debt, can reasonably add to that debt by an amount that covers most of its interest obligations. The implied capital account surplus negates much of the need for a trade surplus.

With respect to the second consideration, it must be recognized that in many countries, debt service is first and foremost a fiscal problem, and only secondarily a trade issue. Governments that are directly responsible for most of the external debt obviously must first obtain the financial resources for debt service in domestic currency before a problem of obtaining the necessary foreign exchange can even arise. Obviously, such governments must take the steps to produce a fiscal surplus in their domestic-currency budgets in order to pay any positive net debt service. The fiscal problems in the Latin American countries, particularly Argentina, are too well known to require more than mere mention here. Again, the Korean situation appears to be more favorable than that in much of Latin America. According to Korean Ministry of Finance estimates, the 1984 fiscal deficit of 1.06 trillion won

will amount to 1.6 per cent of 1984 Korean GDP, in comparison with estimates ranging from 12 to 20 per cent for Argentina.[7]

Finally, there is the degree to which the recent appreciation of the dollar has worsened the debt service problem. To analyze that, we shall combine equations (2) and (7). The latter can be written as:

$$NDS = D[i - g - (\dot{d}/d)] \quad , \tag{7'}$$

which, in real terms, becomes:

$$RNDS \equiv NDS - \Pi_D^t(D) \quad , \tag{8}$$

and hence real net debt service as a fraction of GDP becomes:

$$\begin{aligned} RNDS/Y &= d[(i - \Pi_D^t) - g - (\dot{d}/d)] \\ &= d[R - g - (\dot{d}/d)] \quad , \end{aligned} \tag{9}$$

where Π_D^t is the (country-specific) rate of inflation of dollar prices of traded goods defined in equation (1) and R is the (country-specific) real rate of interest on external debt as defined in equations (2), (3) and (5). As was illustrated earlier, appreciation of the U.S. dollar sharply increases R for the Latin American major debtor countries.

The behavior of R, the real rate of interest on external dollar-denominated debt, will not be the same for all debtor countries. We have seen that for Latin American countries, R responds sharply (and positively) to appreciation of the U.S. dollar with respect to other major currencies, indicating the strong appreciation of the dollar during the course of 1984 has worsened their external debt situation. For other countries, trade patterns are such that they are less affected by dollar appreciations and depreciations. Tentative

evidence indicates that Korea falls into the latter group, perhaps because of its emphasis on manufactured rather than commodity exports.[8] The quantitative importance of this difference is, however, yet to be ascertained. It goes without saying, of course, that this effect is like a double-edged blade; a depreciation of the dollar would appear to help Korea less than the Latin American countries.

CONCLUDING COMMENTS

A great deal of emphasis has been placed on world economic recovery and trade liberalization (or at least avoiding further protectionism) as key elements in the resolution of the external debt problem currently facing the developing countries. This paper does not deny that those factors play an important role, but I have chosen to underscore other, and what I believe to be equally significant, elements. The role of an international monetary system in bringing about the problem is at least as important as are trade-related developments in perpetuating that problem. The role of debtor-country fiscal deficits, both as the raison par excellence for debt accumulation, particularly in Latin America, and the greatest single obstacle to debt service in that same region, has received far too little attention (except, perhaps by the IMF). The role of high nominal dollar interest rates, although widely proclaimed, is almost totally absent in explaining the behavior of real interest rates on external debt.

It is argued in this paper that in the most acute situations, no external developments that might be imagined can resolve the debt issues; either a major write-down of the debt or default is the only solution. For the other countries, those which owe the bulk of the debt, domestic fiscal austerity and policies aimed at removing internal barriers to economic growth are essential. For the remainder of the countries, one of the most useful endeavors that one can recommend is restoration of stability to the world monetary system.

FOOTNOTES

[1]See L.A. Sjaastad, "The International Debt Quagmire: To Whom do we Owe It?", The World Economy, September, 1983.

[2]The ratio of debt to exports for all of Latin America is estimated to have have been 5.2 in 1913; see W. Arthur Lewis, Growth and Fluctuations, 1870-1913.

[3]See Nasser Saidi, "Public Debt, Expenditure and Revenue, Panama 1956-83: Assessment and Policy Recommendations," (mimeo, Geneva, 1984). Saidi estimates total public sector debt of Panama to have been $4.467 billion in 1983, almost identical if gross internal product. In the same year, exports were about 38 per cent of gross internal product.

[4]From mid-1980 to early November, 1984, the DM price of the U.S. dollar rose by over 65 per cent.

[5]See L.A. Sjaastad, "Exchange Rate Regimes and the Real Rate of Interest," forthcoming in Economics of the Caribbean Basin, edited by Michael Connolly and John McDermott, Praeger Publishing Company, 1985 (available spring, 1985).

[6]Because of substantial fluctuations in actual exchange rates relative to purchasing power parity rates, the dollar estimates of the GDP figures for a number of countries have changed violently since 1980. As a consequence, the debt to GDP ratios cited in the text are only approximations.

[7]Comprehensive fiscal deficit data are increasingly difficult to obtain because much of the spending is "off budget." In Argentina, for example, the Central Bank has a major financial deficit, and Brazil nearly all of the fiscal deficit is incurred by the Banco do Brasil. Both institutions are outside the usual definitions for fiscal purposes.

[8]According to the October, 1984 issue of the IMF International Financial Statistics, the index of dollar export unit values fell by 10.2 per cent from 1980 to 1983 (annual averages) for the industrial countries, and the index of dollar import unit values fell by 12.5 per cent. For Korea, on the other hand, those unit values fell by 4.5 and 8.0 per cent, respectively. The Central Bank of Chile, in its September, 1984 Boletin Mensual, estimates that a similar index of Chilean export unit values fell by 27.6 per cent while the index of import unit values fell by 14.3 per cent. Thus the deflationary effects of the dollar appreciation were less severe for Korea than for the industrialized countries, and far less severe than for Chile, for which commodity exports are very important. Note that the IMF index of dollar prices of commodities fell by 19.9 per cent during this period.

○